72-1616

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-1616

BOGUE ELECTRIC MANUFACTURING CORPORATION, EDWARD P. SCHINMAN, ROBERT S. HERWIG, WILLIAM S. GUTTENBERG and MURRAY REIFFIN,

Petitioners,

—v.—

HERMAN L. ZELLER, IRWIN SMALL COMPANY, a Partnership, and BELCO POLLUTION CONTROL CORPORATION,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Petitioners,

—v.—

HERMAN L. ZELLER, IRWIN SMALL COMPANY, a Partnership, and BELCO POLLUTION CONTROL CORPORATION,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit which reversed the District Court's order and judgment granting summary judgment in favor of petitioners dismissing the complaint.

Citations to Opinions Below

The opinion of the District Court (Appendix B) is reported at 346 F. Supp. 651. The opinion of the Court of Appeals (Appendix A) has not yet been officially reported but has been reported at ¶93, 903 CCH Fed. Sec. L. Rep. [Current Binder].

Jurisdiction

The judgment of the Court of Appeals was entered on March 22, 1973. Petitioners' application for rehearing and application for rehearing in banc was denied by two orders dated April 24, 1973. The Court of Appeals stayed its mandate for 30 days by order dated May 8, 1973. The time for filing this petition expires on June 20, 1973.

The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

Questions Presented for Review

1. Whether under §28(a) of the Securities Exchange Act which limits recovery to "actual damages," an allegedly defrauded buyer, whose out of pocket loss has been fully recompensed may also recover such non-out of pocket items as lost profits, gains prevented and consequential damages.

2. Whether a measure of damages appropriate to state law claims of corporate mismanagement should be incorporated into the anti-fraud provisions of the federal securities laws.

Statutes and Federal Rules Involved

1. The Securities Exchange Act of 1934, §10b (15 U.S.C. §78j(b)) and Rule 10b-5 thereunder (17 C.F.R. §240.10b-5.

2. The Securities Exchange Act of 1934, §28(a) (15 U.S.C. §78bb(a)).

3. The Securities Act of 1933, §17(a) (15 U.S.C. §77q(a)).

The text of the foregoing provisions is set forth in Appendix C.

Statement of the Case

Detailed facts are set forth in the opinions of the courts below (Appendices A and B). Respondent Zeller, basing jurisdiction in the first instance on Section 27 of the Securities Exchange Act of 1934 (15 U.S.C. §78aa) and Section 22 of the Securities Act of 1933 (15 U.S.C. §77v), commenced this shareholder's derivative action on behalf of Belco Pollution Control Corp. ("Belco").

Named as defendants were Belco's parent corporation, petitioner Bogue Electric Manufacturing Corp. (hereafter "Bogue"); the members of the interlocking boards of directors of Belco and Bogue and their attorney; and Bogue's accountant, the respondent Irwin Small Company.

The complaint alleged violations of the anti-fraud provisions of the federal securities laws, to wit, §10b of the 1934 Act, Rule 10b-5 thereunder and §17(a) of the 1933 Act (the full text of those provisions is set forth in Appendix C).

The heart of Zeller's claim is corporate mismanagement and breach of directors' and majority shareholders' fiduciary duty. This non-federal claim is couched in terms of a security fraud. Belco is alleged to have been the defrauded buyer in a security transaction when in July 1971 an open account indebtedness of some $300,000 resulting from loans by Belco to Bogue was formalized by Bogue's

issuance of a collateralized demand promissory note payable to Belco.

In May, 1972, the loans were fully repaid together with accrued interest at the rate of 8%. Zeller, claiming the loans were not made for any proper business purpose of Belco thereupon moved for summary judgment on the issue of liability. Petitioners cross-moved for summary judgment dismissing the complaint on the ground that with repayment of the loans Belco was recompensed for all recoverable out of pocket loss thereby mooting any federal securities laws claim. The District Court (per Gurfein, *J.*, Appendix B) dismissed the complaint, holding that under §28(a) of the 1934 Act the pre-*Erie* federal rule of fraud damages was applicable to the federal securities laws; and as Belco had been compensated for all out of pocket loss, it no longer had any claim under those laws. The Court of Appeals reversed and held (Appendix A) that a defrauded buyer may recover such non-out of pocket items of alleged damage as the following:

(a) gains prevented, including (1) any greater interest rate which Belco could have obtained by lending the money to others, (2) higher earnings which Belco might have made by investing the money in its own business and (3) proceeds of an allegedly lost underwriting which might have supplied Belco with additional capital funds.

(b) "disgorgement" of "profits" made by the alleged defrauder including (1) any increased interest which Bogue would have had to pay on a loan above the 8% actually paid to Belco, and (2) the alleged profit made by Bogue on the sale of the stock which collateralized the promissory note.

REASONS FOR GRANTING THE WRIT

POINT I

Certiorari should be granted in view of the clear conflict between the Second and Tenth Circuits as to the proper measure of a defrauded buyer's recoverable damages under the Federal Securities Laws.

Prior to the Court of Appeals' decision in this case, damages recoverable by an allegedly defrauded buyer under the anti-fraud provisions of the federal securities laws were consistently held to be measured by the out of pocket rule of fraud damages. The Tenth Circuit in *Estate Counselling Service, Inc.* v. *Merrill, Lynch, Pierce, Fenner & Smith,* 303 F.2d 527, 533 (1962) summarized the law as follows:

> "The failure to show actual damages is also a fatal defect in the cause of action based on the Securities Exchange Act of 1934, 15 U.S.C.A. §78a et seq. That Act permits recovery of 'his actual damages on account of the act complained of.' 'Actual damages,' under the Federal rule of damages for fraud is the 'out of pocket rule.' In the Federal courts the measure of damages recoverable by one who through fraud or misrepresentation has been induced to purchase bonds or corporate stock, is the difference between the contract price, or the price paid, and the real or actual value at the date of the sale, together with such outlays as are attributable to the defendant's conduct. Or in other words, the difference between the amount parted with and the value of the thing received. [citing cases]."

Following the *Estate Counselling* rule that a defrauded buyer-plaintiff is entitled to recover only "such moneys as plaintiff has paid out, with interest, and any other *outlay* legitimately attributable to defendant's fraudulent conduct * * *" (Ibid., *emphasis added*) are other Tenth Circuit decisions (see, *Esplin* v. *Hirschi*, 402 F.2d 94, 104 (1968) *cert. den.* 394 U.S. 928 (1969); *Richardson* v. *MacArthur*, 451 F.2d 35, 43 (1971), and the Ninth Circuit in *Sackett* v. *Beaman*, 399 F.2d 884, 891 (1968). The out of pocket rule for buyers has also been approved in dicta in other circuits (see, *Janigan* v. *Taylor*, 344 F.2d 781, 786 (1st Cir. 1965), *cert. den.* 382 U.S. 879 (1965); *Mysel* v. *Fields*, 386 F.2d 718, 745 (8th Cir. 1967), *cert. den.* 390 U.S. 951 (1968); *Kohler* v. *Kohler*, 208 F. Supp. 808 (E.D. Wisc. 1962), *aff'd* 319 F.2d 634 (7th Cir. 1963) and has even been specifically approved by the Second Circuit in its prior decisions (see, *S.E.C.* v. *Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1104 (1972); *Levine* v. *Seilon*, 439 F.2d 328, 334 (1971)).

By allowing an allegedly defrauded buyer to recover such non-out of pocket elements of purported damages as those listed above, the Court of Appeals has made a clear break from the foregoing authorities and has established a rule of law totally inconsistent with the Tenth Circuit's holdings.

POINT II

Certiorari should be granted as there is no logical basis upon which an expanded measure of damages can be sustained; any such expansion would be contrary to the prior holdings of this Court.

To justify its departure from the settled law the Court of Appeals referred to this Court's decision in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972) which approved the First Circuit's holding in *Janigan* v. *Taylor*, *supra*, that defrauded *sellers* are entitled not only to their out of pocket loss (i.e., the difference between the value of what they sold and what they got) but also any additional profits realized by the defrauding buyer (Appendix A, p. 11a). We respectfully submit that the Court of Appeals erred in not recognizing the essential difference between buyers and sellers, which difference of necessity precludes application of the seller's rule to buyers. That essential difference is the nature of the property parted with—the buyer parting with money while the seller parts with a property or commodity other than money.

In *Janigan*, *supra*, 344 F.2d at 786, where the seller's disgorgement rule was first established, Judge Aldrich was careful to draw a distinction between buyers' and sellers' remedies, holding with respect to defrauded sellers that:

> "future accretions not foreseeable at the time of the transfer even on the true facts, and hence speculative are subject to another factor, viz., that they accrued to the fraudulent party."

The seller's disgorgement theory thus is built upon two bases: (1) there are accretions to the property transferred; (2) restitutional principles of unjust enrichment. If applied to buyers it is readily apparent that one of these bases is absent and with that the disgorgement rule fails to apply. The buyer parts with money. There are no "accretions" to the money. Any profits accruing to the defrauder result from the *use* to which the fraudulently obtained money is put.* The seller, however, parts with property other than money, typically shares of stock or other security. As these properties generally have a fluctuating value, any "accretions" necessarily involve the increased value of the property itself; logically such profit should be disgorged as the defrauded seller would have had the benefit of those accretions but for the fraud. In *Janigan,* for example, the seller parted with shares of stock which increased in value after the fraudulent sale. It was this profit which but for the fraud would have accrued to the plaintiff who would still have had the security in his pocket when the increased value became available. In our case, as in any typical buyer's case, the alleged profits which plaintiff seeks to compel be "disgorged" have nothing whatsoever to do with the property (i.e., the money) parted with, and there is no way in which Belco would have had the benefit of those "profits" but for the fraud. The disgorgement theory, therefore, is not applicable and makes no sense when applied to a buyer, and the Court of Appeals erred in applying it.

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* In *S.E.C.* v. *Manor Nursing Centers, Inc., supra,* 458 F.2d at 1104 the Second Circuit recognizing the distinction between buyers and sellers specifically held that any profits or income resulting from a seller's use of money fraudulently obtained from a buyer could not be recovered under the disgorgement rationale.

Moreover, the disgorgement rule as applied to buyers runs afoul of this Court's holdings in the touchstone securities fraud cases of *Smith* v. *Bolles*, 132 U.S. 125 (1889), and *Sigafus* v. *Porter*, 179 U.S. 116 (1900). These cases established the pre-*Erie* federal rule of fraud damages for a buyer of securities. That rule, commonly referred to as the out of pocket rule, is summarized by this Court's words in *Bolles* where it held at 132 U.S. 129, "[w]hat plaintiff might have gained is not the question, but what he had lost by being deceived into the purchase," and in *Sigafus* where it held at 179 U.S. 123 that "the true measure of damages suffered" for fraud "is the difference between the actual value of that which he parts with and that which he receives under the contract. It is the loss which he sustained and not the profits which he might have made by the transaction."* The out of pocket rule for fraud damages enunciated in these cases (with the disgorgement rule engrafted for sellers) has universally been held to be the applicable rule for damages under the anti-fraud provisions of the federal securities laws (see authorities cited in Point I, *supra;* 2 Bromberg, *Securities Law, Fraud, S.E.C. Rule 10b-5,* §9.1). Each and every item of damage which plaintiff seeks to recover represents a non-out of pocket item and, hence, is not within the scope of recoverable fraud damages. Judge Friendly attempts to avoid this conclusion by classifying two items

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* The rationale of this Court's opinion in *Bolles* and *Sigafus* is approved by the Restaters, who have noted that:

> "Logically the out-of-pocket rule appears beyond argument to be the proper rule for a tort action, since the purpose of such action is to compensate for loss sustained, and restore the plaintiff to his former position, and not give him the benefit of any contract he may have made." Restatement of Torts 2d, Tent. Draft #11, §549 Note 4.

of alleged damage (the 40% return on capital which Beleo supposedly could have made by investing the loaned funds in its own business, and the $800,000 lost benefit of a proposed underwriting) as "consequential" damages which admittedly "are in addition to or in lieu of what ordinarily constitute a fair recovery" (Appendix A, p. 14a). Of course, these supposedly consequential damages are not out of pocket items but represent gains which Beleo allegedly was prevented from making. By allowing recovery of such gains prevented the Court of Appeals has, in effect, returned to the concededly rejected "benefit of the bargain" rule of fraud damages in that an allegedly defrauded buyer is not compensated merely for losses sustained but is given the benefits which would have accrued had there been no fraud.* The refusal of the Court of Appeals to follow the buyer's rule of damages set forth in *Bolles* and *Sigafus* should be corrected by this Court or this case will stand as an aberration in the well settled federal securities law.

POINT III

Certiorari should be granted because the decision of the Court of Appeals will result in the federal courts being deluged by state law claims.

In expanding the scope of recoverable damages for violation of Rule 10b-5, the decision of the Court of Appeals has changed that rule from an anti-fraud regulation to a substitute vehicle for what are properly state court cases

* None of the textwriters or authorities cited by the Court of Appeals (see Appendix A, p. 14a) in any way hint that in a business transaction lost profits are a proper element of consequential damages.

of corporate mismanagement and violation of fiduciary duty. The effect will be to open the doors of the federal courts, with nationwide jurisdiction, to any claim of corporate mismanagement touching upon the purchase or sale of a security.

State law bonding requirements will no longer serve as a deterrent to ill-founded claims of corporate mismanagement.

This very lawsuit is a prime example. The reality of the complaint is a charge of corporate mismanagement—interlocking directors improperly causing a subsidiary to make illegal loans to its parent corporation. The damages claimed are those which plaintiff would have claimed in a stockholder's derivative action in the courts of New Jersey, New York or Delaware. All of those states have stringent bond requirements. Yet, by attaching those claims to a claim of 10b-5 violation, plaintiff, a citizen and resident of Pennsylvania, has been able to sue in the Southern District of New York, a New Jersey corporation, a Delaware corporation and four citizens of New Jersey, none of which corporations or individuals are in New York, and the Court of Appeals has held that the damages which might be recovered in the courts of New Jersey, New York or Delaware for corporate mismanagement may be recovered in the federal court as damages for a 10b-5 violation and not merely under pendent jurisdiction of state court claims.

Neither the Congress, in enacting the securities laws, nor the Securities Exchange Commission in formulating Rule 10b-5 could have intended such a strange result. Under the decision by the Court of Appeals, §10(b) and Rule 10b-5 will cease to be anti-fraud securities regulations.

They will become corporation regulatory rules, under which the federal courts will be called upon to develop their own substantive federal corporation laws. This Court in *Superintendent of Insurance* v. *Bankers Life & Casualty*, 404 U.S. 6 (1971) did approve a limited application of 10b-5 to cases of corporate mismanagement, and in the *Ute* case, *supra*, it approved the disgorgement rule as applied to defrauded sellers. Whether to now stretch those two cases and say that the disgorgement rule should be applied to buyers together with the other rules of state law damages concerning corporate mismanagement and breach of fiduciary duty is a question of such great importance that it should be passed upon by this Court.

CONCLUSION

For the reasons given, petitioners pray that the writ be granted.

Respectfully submitted,

ROBERT L. KLEIN
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APPENDIX A

Opinion of the Court of Appeals, Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 445—September Term, 1972.

(Argued February 13, 1973 Decided March 22, 1973.)

Docket No. 72-2004

HERMAN L. ZELLER,

Plaintiff-Appellant,

v.

BOGUE ELECTRIC MANUFACTURING CORPORATION, EDWARD P. SCHINMAN, ROBERT S. HERWIG, WILLIAM S. GUTTENBERG, MURRAY REIFFIN, IRWIN SMALL COMPANY, a Partnership, and BELCO POLLUTION CONTROL CORPORATION,

Defendants-Appellees.

Before:

FRIENDLY, *Chief Judge,*
OAKES, *Circuit Judge,* and DAVIS, *Judge.**

Appeal from an order of the District Court for the Southern District of New York, Murray I. Gurfein, *Judge,* dismissing, for want of sufficient allegation of damage, a derivative stockholder's action alleging violation of the federal securities laws because of a parent corporation's improperly causing a partly-owned subsidiary to loan it money on terms alleged to have been unfair.

Reversed and remanded.

* Of the United States Court of Claims, sitting by designation.

LAWRENCE M. POWERS, Esq., New York, New York (Powers and Gross and Steven E. Gross, Esq., New York, N. Y., of Counsel), *for Plaintiff-Appellant.*

ALEXANDER STONE, Esq., New York, New York (Beeker, Ross & Stone, James J. Ross, Esq., and William C. Kratenstein, Esq., New York, N. Y., of Counsel), *for Defendants-Appellees Bogue Electric Mfg. Corp., Edw. P. Schinman, Robert S. Herwig, Wm. S. Guttenberg and Murray Reiffin.*

RICHARD G. MCGAHREN, Esq., New York, N. Y., *for Defendant-Appellee Irwin Small Company.*

BARRY KESSLER, Esq., New York, N. Y., *for Defendant-Appellee Belco Pollution Control Corporation.*

FRIENDLY, *Chief Judge:*

Appellant Zeller, a stockholder of Belco Pollution Control Corporation (Belco), a Delaware corporation having its principal offices in New Jersey, brought this derivative action in the District Court for the Southern District of New York against Bogue Electric Manufacturing Corporation (Bogue), a New Jersey corporation, four individuals who were directors of both Belco and Bogue, and Belco's accountants. Federal jurisdiction was predicated on § 27 of the Securities Exchange Act of 1934, § 22 of the Securities Act of 1933, and pendent jurisdiction.

The principal allegations of the complaint were as follows: In 1968 Bogue caused Belco to be incorporated

and later that year to make a public offering of 200,000 of its $10,000 common shares, with 600,000 unregistered shares being retained by Bogue, which exercised effective control over Belco. During 1969 Bogue suffered from accelerating operating losses and a deteriorating working capital position. In contrast, Belco, as a result of receiving approximately $1,000,000 from the public offering and operating earnings, was accumulating cash which was necessary for its growing business. During 1970 the four individual defendants caused Belco to make a series of open-account loans to Bogue for which "no interest was required to be paid." At the year end the loans totaled $202,130, and by June 30, 1971 they had increased to $315,310. On July 1, 1971, the open account indebtedness was replaced by a demand interest bearing promissory note,[1] collateralized by 150,000 shares of Belco stock owned by Bogue and to be held by a trustee. Subsequent disclosure of the loan by Belco to Bogue was claimed to have aborted a further public offering of Belco shares which would have yielded Belco at least $800,000.[2] The conduct of Bogue and the individual defendants was alleged to have violated § 10(b) and Rule 10b-5 of the

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1 A copy of the promissory note, annexed as an exhibit to plaintiff's affidavit in support of his summary judgment motion, reveals that the rate of interest was 8%.

2 In August 1971, the underwriter proposed an offering of 150,000 units of Belco securities, each unit being composed of two shares of Belco common stock and one warrant exercisable into Belco common stock. Belco and Bogue were each to sell 75,000 units, and the unit price was not to exceed $11. The body of the complaint contains a claim that the proceeds of the offering would have been $1,650,000, yielding Belco at least $800,000, but the *ad damnum* speaks in terms of $1,500,000 "which would have been the proceeds of the proposed offering." Additional correspondence annexed as exhibits to appellant's affidavit in support of his motion for summary judgment indicate that modifications in the number of units to be sold in the proposed offering were considered.

Securities Exchange Act, § 17(a) of the Securities Act, and the securities laws of New York and New Jersey, where the improper acts were claimed to have been done. The complaint sought judgment for the amount of all loans by Belco to Bogue with interest at the legal rate of 7¼%[3] and the proceeds of the aborted underwriting, various forms of injunctive relief, and orders awarding attorneys' fees, costs and such other relief as would be just and proper.

After answer, plaintiff moved for summary judgment. Defendants countered with a motion and supporting papers which asked that the complaint be dismissed for want of subject matter jurisdiction, that they be granted summary judgment, or that, in any event, plaintiff's motion for summary judgment be denied.

Plaintiff's moving affidavit added several new matters of importance: Belco's own corporate resolutions recited that the advances had been made "for the corporate purposes of Bogue." Belco itself had suffered losses in 1969 and 1970, with a net decrease of working capital of $629,828 in the latter year, and thus was in no position to loan substantial sums to its parent. Plaintiff alleged that during 1970 "some of the most successful corporations in America were paying 10% to 12% per annum to borrow money from banks and other sources of financing because of 'tight money' conditions," were often required to give sweeteners in the form of options, warrants, or other securities, and were required to keep compensating balances of as much as 20% of the sums borrowed, thus making the effective rate for low risk borrowers as high as 15% per annum. For the first nine months of 1971 Belco had

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3 Plaintiff is not, of course, limited to the *ad damnum* stated in the complaint. See, *e.g.*, *United States ex rel. Bergen Point Iron Works* v. *Maryland Casualty Co.*, 384 F.2d 303 (2 Cir. 1967); *Kahan* v. *Rosenstiel*, 424 F.2d 161, 174 (3 Cir.), *cert. denied*, 398 U.S. 950 (1970). See generally 6 Moore, Federal Practice ¶ 54.62 (2d ed. 1972).

earned 40% on its invested capital. Also, after the action had been brought, Bogue had sold its interest in Belco to Foster-Wheeler Corporation.[4]

Defendants' affidavits supplied more details: Bogue had sold its 600,000 Belco shares to Foster-Wheeler for $1,650,000. Upon the closing on May 1, 1972, the amount owing from Bogue to Belco with 8% interest from the date of each advance was paid,[5] and the 150,000 Belco shares that had collateralized Bogue's promissory notes were included in the transfer to Foster-Wheeler. It was alleged that the loans to Bogue were in Belco's best interest and that Belco had derived other benefits from its association with Bogue which must be taken into account in any determination whether Belco had been wronged and, if so, how much.

The district judge granted defendants' motion for summary judgment and dismissed the complaint. He did this on the basis of the provision in § 28(a) of the Securities Exchange Act which entitles a plaintiff to recover only "actual damages on account of the act complained of" and his conclusion that, under the "federal" rule whereby a defrauded buyer is entitled only to the difference between the amount parted with and the amount received, see *Smith* v. *Bolles*, 132 U.S. 125 (1889); *Levine* v. *Seilon, Inc.*, 439 F.2d 328, 334 (2 Cir. 1971), rather than the "benefit of the bargain" rule applied in such actions by many states, see Prosser, Torts § 110, at 734 (4th ed. 1971), repayment of

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4 Both the complaint and the moving affidavit contain many allegations of alleged falsities and nondisclosures in Belco's reports to the SEC and to stockholders. The pertinence of all this in a derivative stockholder's action on behalf of Belco escapes us, unless the plaintiff is attempting to provide thereby proof of an intent to defraud.

5 Defendants also disputed plaintiff's claim that interest had not been accrued on the open-account advance; they claimed this had been charged on Bogue's books at the rate of 8%.

the loan with interest had eliminated any compensable loss. From this ruling plaintiff appeals.

I.

Defendants urge that, whether or not we agree with the court's holding that Belco could not establish any damages, the complaint should have been dismissed because it did not allege fraud in connection with the purchase or sale of a "security." In analyzing this argument it will be convenient to treat the case in the first instance as if Bogue had issued demand notes collateralized with Belco stock from the outset and then consider whether a different result is required because until July 1, 1971, Bogue's indebtedness was evidenced only on open account.

The Securities Act of 1933 and the Securities Exchange Act of 1934 differ in their method of handling short-term commercial paper. Under the 1933 Act, while § 2(1) provides that any note is a "security," § 3(a)(3) exempts from the registration and prospectus requirements "[a]ny note, draft, bill of exchange, or bankers' acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." However, § 17, the general anti-fraud provision, provides in subsection (c) that the exemptions of § 3 shall be inapplicable. Instead of following this model in the Securities Exchange Act, Congress defined "security," § 3(a)(10), to include "any note" but inserted in the same clause that this would not include "any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." If the letter of the 1934 Act

is followed, paper falling within this proviso is thus excluded from all provisions of the 1934 Act, including those dealing with fraud.

A short answer to the question whether Bogue's demand note came within the exclusion of § 3(a)(10) could be that it makes no difference, since the only consequence of an affirmative answer would be predication of liability on § 17(a) of the 1933 Act, if that section created a private right of action. See *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 867-68 (2 Cir. 1968) (Friendly, *J.*, concurring), *cert. denied*, 394 U.S. 976 (1969); 3 Loss, Securities Regulation 1785-86 (2d ed. 1961) and 6 Loss, Securities Regulation 3912-15 (Supp. 1969). Be that as it may, we believe Bogue's note is not within the exclusion of § 3(a)(10) of the Securities Exchange Act.

Here again there is a short way to answer the question should we wish to take it. The SEC has made clear its view that the nine-month standard of § 3(a)(3) of the 1933 Act is not met by obligations payable on demand. Securities Act Rel. No. 4412 (1961), 26 Fed. Reg. 9158, 9159 (1961). Presumably it would take the same view with respect to the exclusion in § 3(a)(10) of the 1934 Act. Whatever the proper answer to this question in general, we would have little doubt of the validity of such a position in a case like this where the maker of the note could prevent any demand by the holder and the note was outstanding for ten months.

We think it preferable, however, to rest our decision on the basis that even if demand paper could ever qualify for the § 3(a)(10) exclusion—which we do not decide, see ALI, Federal Securities Code, Tent. Draft No. 1 § 216A and comment on pp. 71-72 (April 1972)—Bogue's note would not. The SEC has taken the position with respect to the exemptive provision of § 3(a)(3) of the Securities Act, Se-

curities Act Rel. No. 4412, *supra*, 26 Fed. Reg. at 9159, that:

> The legislative history of the Act makes clear that section 3(a)(3) applies only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper used to facilitate well recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks.[6]

We have no doubt that the Commission would take the same view with respect to the exclusion in § 3(a)(10) of the Securities Exchange Act.[7] See 2 Loss, Securities Regulation 796 (2d ed. 1961). Such a ruling, by an agency charged with the administration of a statute, while not conclusive, is entitled to substantial weight. *Skidmore* v. *Swift & Co.*, 323 U.S. 134, 140 (1944). We thus agree with the decision of the Seventh Circuit in *Sanders* v. *John Nuveen & Co., Inc.*, 463 F.2d 1075, *cert. denied*, 41 U.S.L.W. 3274 (1972), that the mere fact that a note has a maturity of less than nine months does not take the case out of Rule

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6 In explaining the House bill's § 3(3) exemption, which was ultimately enacted into law without amendment, the House Committee report states that "[p]aragraph (3) exempts short-term paper of the type available for discount at a Federal Reserve bank and of a type which rarely is bought by private investors." H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933). Since this statement was quoted and relied upon by the SEC in its release, Professor Loss' criticism of the Commission's reliance on S. Rep. No. 47, 73d Cong., 1st Sess. 3-4 (1933), for failing to mention that the Senate bill, the focus of the report, had provided in § 2(a) that the paper must not be "offered or intended to be offered for sale to the public," see 4 Loss, Securities Regulation 2590 (Supp. 1969), though technically correct, does not seem to undermine the validity of the SEC's position.

7 The Senate Report on the Securities Exchange Act stated that the definition of security was intended to be substantially the same as that contained in the Securities Act, S. Rep. No. 792, 73d Cong., 2d Sess. 14 (1934), quoted in *Tcherepnin* v. *Knight*, 389 U.S. 332, 342 (1967).

10b-5, unless the note fits the general notion of "commercial paper" reflected in the SEC Release. See also *Anderson* v. *Francis I. duPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968) (short-term notes); *cf. United States* v. *Hill*, 298 F. Supp. 1221, 1226-27 (D. Conn. 1969) (high risk 6-month notes held not exempt from the registration requirements of the Securities Act of 1933); Bromberg, Securities Law: Fraud SEC Rule 10b-5 § 4.6(317) (1969). We see nothing in *SEC* v. *Fifth Avenue Coach Lines, Inc.*, 435 F.2d 510, 517 (2 Cir. 1970), which would lead to a contrary conclusion, though the district court opinion contains dicta with which we would not agree, see 289 F. Supp. 3, 38 (S.D.N.Y. 1968).

It does not follow, however, that every transaction within the introductory clause of § 10, which involves promissory notes, whether of less or more than nine months maturity, is within Rule 10b-5. The Act is for the protection of investors, and its provisions must be read accordingly. See *Movielab, Inc.* v. *Berkey Photo, Inc.*, 452 F.2d 662 (2 Cir. 1971). But we see no reason to doubt that Belco stood in the position of an investor, although perhaps an involuntary one, with respect to Bogue. We thus hold that, if at the outset the transaction had taken the form of Belco's buying Bogue's demand note, Rule 10b-5 would apply.

However, we are unable to find anything in the definition of security in the Securities Exchange Act that would cover an advance on open account. In this respect the omission, in the 1934 definition, of the words "evidence of indebtedness" contained in the definition in § 2(1) of the 1933 Act would seem to have a significance which, for good reasons, the Supreme Court found lacking on the facts before it in *Tcherepnin* v. *Knight*, 389 U.S. 332, 344 (1967). Arguably this would mean that damages must be limited to those accruing after July 1, 1971.

However, such a conclusion would fail to take suitable account of plaintiff's claim that Bogue's use of its control over Belco to compel a loan which was in Bogue's interest but not in Belco's violated applicable state law. If the issuance of the note created a claim under Rule 10b-5, any damages suffered earlier can be awarded in the exercise of pendent jurisdiction.[8]

II.

Analysis of plaintiff's claims reveals five different bases for his contention that payment of the note with 8% interest may not have adequately compensated Belco:

1) Belco could have obtained more than 8% interest, at least from a borrower in what is alleged to have been the precarious financial condition of Bogue, during the period of tight money conditions that prevailed during part or all of the time when Bogue's debt was outstanding;

2) Bogue would have had to pay more than 8% to obtain funds during part or all of the period;

3) The loan enabled Bogue to profit by selling the 150,000 Belco shares pledged as collateral for $412,500 (a quarter of the total price paid by Foster-Wheeler), since otherwise Bogue would have been obliged to sell these shares 10 months earlier under distress circumstances and before Belco had experienced a highly profitable period;

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8 Appellee has not argued and, in the light of *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), could not successfully argue that, if the note was a security, Rule 10b-5 was inapplicable because the case simply raised an issue of a controlling corporation's taking advantage of a controlled subsidiary. See also *Schoenbaum* v. *Firstbrook*, 405 F.2d 215, 219-20 (2 Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969), and *Drachman* v. *Harvey*, 453 F.2d 736 (2 Cir. 1972) (en banc), where, however, the transactions were in securities of the controlled corporation.

4) The intercompany loan deprived Belco of the benefits of a new underwriting in late 1971 from which it would have realized at least $800,000, see fn.2, *supra;* and

5) Belco could have earned more than 8% by using the loaned funds in its own business.

The parties have argued the case as presenting the question whether the principle of *Janigan* v. *Taylor,* 344 F.2d 781, 786-87 (1 Cir.), *cert. denied,* 382 U.S. 879 (1965); *Myzel* v. *Fields,* 386 F.2d 718, 748-49 (8 Cir. 1967), *cert. denied,* 390 U.S. 951 (1968); and now *Affiliated Ute Citizens v. United States,* 406 U.S. 128, 154-55 (1972), whereby, in addition to the usual measure of damages, defrauders will be forced to disgorge windfall profits, applies when the defrauded party is a buyer as well as when he is a seller. Although most of plaintiff's theories do not involve that issue and the ones that do may fail on different grounds, we think it desirable to state our views since the question is fairly raised.

We do not consider the cited cases, or our own decision in *Levine* v. *Seilon, Inc., supra,* 439 F.2d at 334, as having established any such bright line between defrauded sellers and defrauded buyers as defendants urge. The actual holdings in *Janigan* and *Ute* were that defrauded sellers were entitled not only to the difference between the value of what they sold and what they got but also any additional profits realized by the defrauding buyer.[9] The Supreme Court in *Ute* did not discuss the problem with respect to the defrauded buyer. As indicated above, the thrust of Chief Judge Aldrich's dictum with respect to defrauded

9 *Myzel* went beyond this and permitted, under the special circumstances of that case, an award for "'the subsequent increases in the value of the stock over . . . a reasonable period,'" 386 F.2d at 745, apparently whether the buyer resold or not. We take no position on that question here.

buyers in *Janigan* and of what we said on the same subject in *Levine* was to repudiate the "benefit of the bargain" rule in cases arising under the Securities Exchange Act. See also *Estate Counseling Service, Inc.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 533 (10 Cir. 1962). Such repudiation does not necessarily call for a rule that, if a fraudulent seller can be shown to have made a windfall profit, principles of the law of restitution do not require that he be made to disgorge it. See 6 Loss, Securities Regulation 3923 (Supp. 1969). The reason why the remedy has been applied for the benefit of defrauded sellers but not of buyers is not any decisive legal difference but the difficulty generally confronting the defrauded buyer in showing that the fraudulent seller has in fact reaped such a profit.[10]

Plaintiff's first theory of damages does not present the problem just discussed. This claim is, in essence, that the 8% note and the preceding open account debt were not worth what Belco paid for them. We cannot agree with the district court that damage to a subsidiary from fore-

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10 There may be an additional reason for the distinction. Restitution seems to be based not only on a feeling that the party who has acted wrongfully should not be permitted to benefit from his conduct but also that the injured party should be given the benefits of a transaction he would otherwise have been in a position to enter into. The latter consideration is more likely to be present in a securities fraud case where the defrauded party is a seller and the defrauding buyer has subsequently sold the fraudulently acquired securities at a profit, since the higher market price would have been as much of an inducement to the defrauded party to sell the securities as it was to the defrauder. When the defrauded party is a buyer, and the defrauding seller uses the proceeds of a sale to enter into a second profitable transaction, it is far more difficult to say as a general proposition that, if the fraud had not occurred, the defrauded party would also have done this. Nevertheless, absent unusual circumstances, when a buyer has been induced to surrender consideration because of the fraudulent conduct of a seller, it seems appropriate to require the seller to disgorge any profits he would not otherwise have been in a position to realize if these can be traced with sufficient certainty. Compare Restatement of Restitution § 150 (1937), with *id.* § 202.

ing it to loan money to a parent necessarily is fully compensated by the parent's paying off the note, even with a fairly liberal rate of interest, if the subsidiary was in a position to lend money at a higher rate. If Bogue had had outstanding 8% debentures which were selling say at 80, it would be hard to deny that Belco was damaged if Bogue forced it to purchase at 100 such bonds, whether held in Bogue's treasury or an additional issue, even though they were paid at maturity. Yet this hypothetical does not differ essentially from what plaintiff asserts to have been the situation here. To be sure, the fact that Bogue would have had to pay more than 8% interest to others, if it be a fact, does not *alone* demonstrate that Belco suffered a loss by loaning at that rate; plaintiff will also have to show that Belco could have made loans at a higher rate. This would require proof that it, a new company engaged in the business of pollution control, could have found borrowers and that it had funds to loan—an assertion rather contrary to plaintiff's fifth theory, namely, that Bogue forced Belco to loan moneys needed to develop its own business.

Plaintiff's second theory of damages, that Bogue owes Belco the difference between the 8% interest it paid Belco and what Bogue would have had to pay in an arm's length transaction, while not precisely a "disgorging" theory, bears some resemblance to it in that it looks to the seller's gain rather than the buyer's loss. While we see no objection to this in principle, Belco would not have been harmed unless it had funds to lend and could have found a borrower willing to pay more than 8%. In practical effect the second theory is thus the mirror image of the first.

The third theory does sound in terms of disgorging a profit. For the reasons indicated we see no sound basis for precluding plaintiff from endeavoring to establish this. But the obstacles in his way are formidable. He will have

to demonstrate not only that Belco was harmed, as he must under the first or second theory, but also that Bogue required the loan to keep alive; that it had no other means of doing so except by selling—not pledging—some of its Belco shares; and that an earlier sale would have resulted in a lower price for the stock.

Plaintiff's fourth and fifth theories do not involve application of *Janigan* and *Ute* to a defrauded buyer but another question of equal importance. This is whether § 28 of the Securities Exchange Act (or, for the period prior to July 1, 1971, applicable state law) permits the recovery of consequential damages for fraud. General principles of tort law allow such damages in such actions, see Restatement of Torts 2d, Tent. Draft No. 11, § 549(1)-(b) and comment d. (1965); McCormick, Damages § 122, at 459-60 (1935); Prosser, Torts, *supra*, § 110, at 735 and cases there cited. We perceive no sound reason for refusing to apply this principle under the Securities Exchange Act. However, we do not wish to arouse unfounded expectations in Zeller or in other potential 10b-5 plaintiffs. A plaintiff seeking consequential damages for fraud, at comomn law or under federal securities legislation, must establish the causal nexus with a good deal of certainty.[11] Since consequential damages are an addition to or in lieu of what would ordinarily constitute a fair recovery, there is no room here for applying the liberal principles of *Eastman Kodak Co.* v. *Southern Photo Materials Co.*, 273 U.S. 359, 379 (1927); *Story Parchment Co.* v. *Paterson Parchment Paper Co.*, 282 U.S. 555, 563 (1931); and *Bigelow* v. *RKO Radio Pictures, Inc.*, 327 U.S. 251, 264 (1946), where some liberality is required to enable an injured plaintiff to recover anything Thus,

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11 We would see nothing wrong in a principle varying the required degree of certainty somewhat inversely with the depth of the fraud.

taking the claim about the aborted underwriting, plaintiff will not carry his burden merely by showing that the loan to Bogue was a factor of concern to the proposed underwriter. He must also show that Bogue was unwilling to meet the underwriter's conditions concerning intercompany borrowings; that but for this the underwriter would have gone forward; that the underwriting would have been accomplished; and that Belco could have used the proceeds in a manner that would have increased per share earnings. And once all this has been demonstrated, Belco should only be permitted to recover as consequential damages what it lost by not being able to make the public offering as originally scheduled; once the loan was repaid, the shares which were to have been offered could presumably have been sold to the public. Similarly, with respect to plaintiff's fifth theory of damages, it would not suffice to show that Belco lost the use of the funds loaned to Bogue; plaintiff must demonstrate that but for defendants' fraud, Belco would have chosen to invest the monies in its own operations; and that Belco could have used the funds more profitably in its own business.[12] While we thus do not take a very bright view of plaintiff's prospects on his fourth and fifth theories, the judge should have allowed him to try.

III.

Plaintiff's request that we enter summary judgment on the issue of liability is completely without merit; defendants have asserted numerous defenses to the claim that

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12 This is not so self-evident as plaintiff assumes on the basis of Belco's profitable 1971 operations. An affidavit of William S. Guttenberg, president of Bogue and former treasurer of Belco, asserted that, in a new scientific equipment manufacturing business like Belco's, "[m]erely putting more capital into such a business will not cause it to grow faster, any more than stuffing more food into a baby will accelerate its growth. The very opposite may happen in both cases."

Bogue misused Belco, which raise triable issues of fact. Equally baseless is plaintiff's request for an immediate award of attorneys' fees on the ground that it was the institution of this action that caused the note to be paid. So far as we can see, what caused the payment was Bogue's sale of its Belco stock to Foster-Wheeler, which provided both the need and the means.

The order granting summary judgment to the defendants and dismissing the complaint is reversed and the cause remanded for further proceedings consistent with this opinion.

APPENDIX B

Opinion of the District Court, Southern District of New York

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

71 Civ. 5502

HERMAN L. ZELLER,

Plaintiff,

—against—

BOGUE ELECTRIC MANUFACTURING CORPORATION, EDWARD P. SCHINMAN, ROBERT S. HERWIG, WILLIAM S. GUTTENBERG, MURRAY REIFFIN, IRWIN SMALL & COMPANY, a partnership, and BELCO POLLUTION CONTROL CORPORATION,

Defendants.

OPINION DATED AUGUST 7, 1972

GURFEIN, *D.J.*

This is a derivative action on behalf of a corporation to recover damages from members of its board of directors, its controlling shareholder and its accounting firm, that accrued as a result of an alleged scheme to defraud the corporation in violation of Rule 10b-5 and §10(b) of the Securities Exchange Act of 1934 (17 C.F.R. §240.10b-5, 15 U.S.C. §78j(b)).[1] The action was commenced December 16, 1971 by a shareholder of Belco Pollution Control Corpora-

[1] The complaint also invokes §17(a) of the Securities Act of 1933 (15 U.S.C. §77q(a)).

tion (Belco) against Bogue Electric Manufacturing Corporation (Bogue), which owned almost 75% of Belco's outstanding shares; and against a group of individual defendants, consisting of an interlocking board of directors between Belco and its parent Bogue; and against a public accounting firm which allegedly participated in the alleged scheme to defraud.

The essential complaint is that the securities laws were violated by the defendants in making and concealing a series of cash advances from Belco to Bogue over a period of two years, ultimately evidenced by a promissory note which is alleged to be a "security" within the meaning of §3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. §78c(a)(10)), and ultimately secured by a purportedly fraudulent and misleading collateral arrangement whereby 150,000 shares of common stock of Belco owned by Bogue were deposited "in trust" in order to secure payment of the note. It is alleged that the factual details of this continuing transaction were concealed in several filings made with the Securities and Exchange Commission (SEC) which were also available to public shareholders; and that the securities transaction complained of resulted in Belco being defrauded of $315,310, with a resulting loss of return on this working capital, over a two year period; and that it also cost Belco additional consequential damages.

The complaint alleges that Bogue and its director-defendants caused Belco to lend it money without security in violation of the securities laws and in breach of their fiduciary obligations to Belco. These loans are alleged to have been made during 1970 and 1971, the total owing to Belco by Bogue as of June 30, 1971 being the sum of $315,310. It was alleged, on information and belief, that such loans had not been repaid. It is further alleged that a disclosure

made to the SEC on Form 10-Q for the six months ended June 30, 1971 was false and misleading;[2] and that the misleading "disclosure" caused an underwriter to walk away from a deal to offer 150,000 units of Belco securities at $11 per unit.

The complaint seeks judgment against Bogue, the individual defendants and the accounting firm for the amount of all outstanding loans, advances and improper withdrawals with interest on the total amount at the rate of 7¼% per annum from the date of each withdrawal of funds complained of. It also seeks an accounting and injunctive relief, in addition to a claim for damages in the amount of $1,500,000 which, it is said, would have been the proceeds of the underwriting. Finally, the plaintiff asks for reasonable attorneys' fees, and costs and disbursements.

The plaintiff now moves for summary judgment on the issue of liability alone under Fed. R. Civ. P. 56(c). He contends that there are no issues of fact regarding liability, but concedes that a hearing would have to be held on the question of damages. The defendants other than Belco oppose the motion for summary judgment and cross-move for summary judgment or for an order dismissing the complaint for want of subject matter jurisdiction pursuant to Fed. R. Civ. P. 12(h)(3).

On this set of motions, the defendants have established by affidavits that the stock of Belco owned by Bogue was

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[2] The disclosure read:

> "The sum of $315,310 as of June 30, 1971, representing loans to its parent Company, Bogue Electric Manufacturing Company was secured on July 1, 1971 by a Promissory Demand Note in that amount plus interest, collateralized by 150,000 shares of investment Belco Common Stock owned by Bogue, which shares are to be held in trust by a designated Trustee pending the payment of such obligation. Such collateralized shares bear an appropriate legend."

sold on May 1, 1972 to the Foster Wheeler Corporation, a stranger, and that Bogue then repaid the entire amount owing to Belco with interest at 8%, more than the 7¼% claimed in the complaint.

The defendants contend that the derivative 10b-5 claim must be dismissed because: (1) Belco suffered no out-of-pocket loss by reason of the alleged acts; and (2) the transactions complained of did not involve a "security" or the "purchase or sale" of a security. The defendants contend that, in any event, summary judgment in favor of the plaintiff cannot be granted because: (1) there are questions of fact relating to breach of fiduciary duty, intent, the use of facilities of interstate commerce, and the adequacy of disclosures; and (2) the complaint fails to allege a deception of Belco.

The facts on which the parties appear to agree substantially are these. The loans were originally made by Belco to Bogue on open account. Later a promissory note of Bogue was given to Belco with 150,000 shares of Belco stock as collateral to be held in escrow against payment by the joint attorney for both corporations. When the consolidated loan was ultimately paid the collateral was turned over to the purchaser, Foster Wheeler, and the promissory note cancelled.

Turning first to the defense that there was no out-of-pocket loss to Belco and hence that there can be no Rule 10b-5 recovery, the question is whether a 10b-5 claim can survive when an improperly made loan has been repaid.[3] That is, is this a case of *damnum absque injuria?*

Under the Securities Exchange Act of 1934, a buyer claiming a violation of 10b-5 must show that he has been

[3] The same reasoning set out in text applies to the claim under §17(a) of the 1933 Act.

damaged.[4] *Estate Counseling Service, Inc.* v. *Merrill, Lynch,* 303 F. 2d 527, 523 (10 Cir. 1962), and see cases there cited; *Smith* v. *Murchison,* 310 F. Supp. 1079, 1084 (S.D.N.Y. 1970); cf. *Levine* v. *Seilon, Inc.,* 439 F. 2d 328, 334 (2 Cir. 1971); *Nichols* v. *Alker,* 231 F. 2d 68, 78 (2 Cir.), *cert. denied,* 352 U.S. 829 (1956).

The long-standing federal rule of damages for fraud is the "out-of-pocket rule," that is, the difference between the amount parted with and the amount received. *Smith* v. *Bolles,* 132 U.S. 125 (1889); *Chandler* v. *Andrews,* 192 Fed. 543, 545 (2 Cir. 1911). This liability does not include the expected fruits of an unrealized transaction. *Smith* v. *Bolles, supra.*

The measure of damages for a 10b-5 claim is fixed by the 1934 statute in Section 28(a) (15 U.S.C. §78bb(a)), which permits recovery only of "his actual damages on account of the act complained of." And "actual damages" has been read to mean out-of-pocket damages for the defrauded buyer, as calculated under the old federal rule for fraud. *Levine, supra; Estate Counseling Service, supra;* 6 L. Loss, Securities Regulation 3923 (1969).

In calculating out-of-pocket loss in this case, it is relevant to note that at common law it has been generally held that a director's liability for wrongfully making or approving a loan is the amount of the loan. 3 W. Fletcher, Cyclopedia Corporations §1343 (1965 rev. vol.), citing *Medford Trust Co.* v. *McKnight,* 292 Mass. 1, 197 N.E. 649 (1935). The defendants are entitled to credit for salvage on the loans. See *Corsicana Natl. Bank* v. *Johnson,* 251 U.S. 68, 86-87 (1919). In other words, the only money

[4] I mention "buyer" because plaintiff contends that Beleo "bought" a "security," i.e., the promissory note of Bogue.

which left Belco's "pocket" was the amount of the loan; on the other hand, the conjectured return, if the loan had been otherwise invested, is not recoverable. Likewise, alleged damages stemming from the abortive underwriting are not only speculative, but do not come within the out-of-pocket rubric.

Since the measurable out-of-pocket loss in this case has been recompensed, there is no longer a claim under §10b and Rule 10b-5; with that falls any claim based on pendent jurisdiction.

Summary judgment is granted on behalf of the defendants.

It is so ordered.

Dated: August 7, 1972.

M. I. GURFEIN
U.S.D.J.

APPENDIX C

Text of Statutes and Federal Rule Involved

1. The Securities Exchange Act of 1934, §10(b) (15 U.S.C. §78j(b))

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

SEC Rule 10b-5 (17 C.F.R. §240.10b-5)

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of a national securities exchange,

(1) to employ any device, scheme or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light

of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

2. The Securities Exchange Act of 1934, §28(a) (15 U.S.C. §78bb(a))

"The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder."

3. The Securities Act of 1933, §17(a) (15 U.S.C. §77q(a))

"It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

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MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-1616

BOGUE ELECTRIC MANUFACTURING CORPORATION, EDWARD P. SCHINMAN, ROBERT S. HERWIG, WILLIAM S. GUTTENBERG and MURRAY REIFFIN,

Petitioners,

v.

HERMAN L. ZELLER, IRWIN SMALL COMPANY, a PARTNERSHIP, and BELCO POLLUTION CONTROL CORPORATION,

Respondents.

BRIEF OF RESPONDENT ZELLER IN OPPOSITION TO A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-1616

BOGUE ELECTRIC MANUFACTURING CORPORATION, EDWARD P. SCHINMAN, ROBERT S. HERWIG, WILLIAM S. GUTTENBERG and MURRAY REIFFIN,

Petitioners,

v.

HERMAN L. ZELLER, IRWIN SMALL COMPANY, a PARTNERSHIP, and BELCO POLLUTION CONTROL CORPORATION,

Respondents.

BRIEF OF RESPONDENT ZELLER IN OPPOSITION TO A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Statement of Facts

This is a stockholder's derivative action for securities fraud on a corporation by controlling persons. The single issue in this case is the measure of recoverable damages for violation of the federal securities laws, when the victim of the fraud is a 75% owned subsidiary corporation, and the fraud consists of forced loans by its parent corporation, at unreasonably low interest rates, at a time when the parent was virtually insolvent and unable to borrow elsewhere. The methods complained of gave the parent use of the subsidiary's monies for inadequate compensation, unconscionable profits and other benefits from the forced

loans. The decision below outlined five areas of recoverable damages inferrable from the particular facts of this case, each subject to a rigorous measure of proof. The unanimous Opinion by Chief Judge Friendly of the Court of Appeals for the Second Circuit (petition for rehearing and rehearing *en banc* denied) states nothing more than that plaintiff, a complaining stockholder of the subsidiary, should have been given the right to prove the facts as to the items of damage potentially recoverable by the victimized corporation. The Opinion below stated carefully drawn elements which plaintiff had the burden to establish for recovery on each of the five items of damages to the subsidiary corporation which were claimed. Petitioners complain that the Court of Appeals somehow changed the law of securities fraud damages, or damages for breach of duty by a corporate fiduciary. But in substance, the Court of Appeals did nothing more than uphold a complaint, and grant to plaintiff his day in Court on behalf of the victimized subsidiary corporation.

The essential facts of this case may be reduced to a brief statement. Bogue Electric Manufacturing Corp. ("Bogue"), and the members of its Board of Directors, and the accountants for Bogue, defendant Irwin Small Company, are claimed to have violated the federal securities laws in forcing a 75% owned subsidiary of Bogue, named Belco Pollution Control Corp. ("Belco"), to loan some $315,000 to the parent corporation in 1970 through 1972, under the following conditions. The parent borrower was virtually insolvent at the time; the lender Belco had paid nearly $400,000 in value and expenses to raise the $315,000 in a public offering the year before; there was no corporate purpose of Belco to be served by the loans; the parent borrower was paying 10½% per annum and giving a first mortgage on real estate with 300% coverage to obtain smaller loans at the time; and Belco was earning some 40% per annum return on capital and had better

use for the $315,000 in cash working capital in its own business, as contrasted with a loan to its parent. Finally, the parent was using the forced financing from the subsidiary to finance the speculative carrying of the parent's 75% stock interest in Belco until Belco's over-the-counter trading price increased, thus netting the parent a substantial profit (some $97,000) on the investment being carried with a forced margin loan from the subsidiary. The salient facts indicated a flagrant abuse of fiduciary responsibility to the public shareholders of Belco who own 25% of its outstanding stock, and showed virtually a weekly "dipping into the till" of Belco by its parent whenever cash was needed in 1970 and 1971. The documentary evidence also showed fraudulent corporate "window dressing" to conceal the abuse of control and misleading filings with the Securities and Exchange Commission, when the forced loans on open account were reduced to a corporate note collateralized by an inadequate block of Belco's own shares pledged by the parent. When sources of public financing discovered the fraudulent loans in 1971, a $1,500,000 equity financing for Belco was cancelled, thus cutting off Belco from future growth as well as the current out-of-pocket damage suffered.

When the plaintiff's stockholder's derivative action was brought against the parent Bogue and the directors responsible for the fraud, Bogue was forced to seek methods for immediate repayment of the loan. This action was commenced in December, 1971, and five months later (after unproductive settlement discussions with the plaintiff), Bogue sold its 75% interest in the subsidiary to a new parent, Foster-Wheeler Corporation, and Bogue was required to pay back the forced loan at the closing of the proceeds of sale. Bogue, on the verge of insolvency, with all credit lines exhausted and several items of corporate debt in default, had no other means of repaying the loans except from the proceeds of sale. Through the abuse of

office, it turned a handsome profit on the Belco shares, repaid the illegal loan and pocketed the fair interest value thereof, and then moved to dismiss plaintiff's case. The District Court, dismissed, and the Court of Appeals reinstated the complaint.

The Court of Appeals made a searching inquiry into the proper elements of damage to Belco, which it could recover against its parent corporation and interlocking directors as a result of this gross fraud upon Belco, virtually conceded in the relevant documents. The case involved the special qualities of securities fraud practiced upon a corporation, by inducing it to issue a note and to accept shares of stock as collateral to secure the note, which was an integral part of a plan of fraud and deceit, as well as misrepresentations and omissions, practiced upon the victimized subsidiary corporation. The fiduciary obligations of the defendants under common law, recognized on many occasions in the enforcement of the federal securities laws, were fused with the normally recoverable damages for violation of the federal securities laws. It is these special kinds of fiduciary damages which Judge Friendly held to be recoverable on the specific facts of the instant case which have led the petitioners to seek certiorari from the Supreme Court.

POINT I

There is No Conflict Between the Circuits on the Measure of a Defrauded Buyer's Recoverable Damages Under the Federal Securities Laws.

The Second Circuit decision delineates the bases of recoverable damages in this case, by dividing them into their categories. First, there are the damages recoverable under the long established "out-of-pocket" rule which even petitioners concede to be a proper measure of damages in a case for federal securities fraud. *Smith* v. *Bolles*, 132

U.S. 125 (1889); *Sigafus* v. *Porter*, 179 U.S. 116 (1900). The recoverable damages under the "out-of-pocket" rule embrace the first two damage elements in the case, i.e., whether 8% per annum interest was a fair interest rate for Belco to be paid in the circumstances of this case. As the Second Circuit says (12a, Petition for Certiorari ["Pet."]) "plaintiff's first theory of damages . . . is, in essence, that the 8% note and the preceding open account debt were not worth what Belco paid for them. We cannot agree with the District Court that damage to a subsidiary from forcing it to loan money to a parent necessarily is fully compensated by the parent's paying off the note, even with a fairly liberal rate of interest, if the subsidiary was in a position to lend money at a higher rate". The facts showed Bogue was forced to pay 10½% per annum in 1971 plus a first mortgage on real estate with 300% coverage for the loan, to borrow merely $150,000 around the same time as these dangerous, and essentially unsecured notes were foisted upon Belco. The facts also showed Bogue had exhausted its borrowing powers by 1971, measured by any businesslike standard of collateral or earning power to secure repayment of further loans. The Court of Appeals then went on to delineate the type of proof required to establish that 8% per annum was an inadequate rate of interest, including a requirement that plaintiff prove Belco, "engaged in the business of pollution control, could have found borrowers and that it had funds to loan . . ." (13a Pet.). The facts presented to the Court below included the high cost of borrowing in 1970, with corporations paying effective interest rates of 15% to 20% per annum, giving effect to compensating balance requirements and "equity" sweeteners in the form of options and warrants required to secure loans during that period of "tight money". Plaintiff's first theory was merely a request that the Court allow it to prove "out-of-pocket" damages by a businesslike presentation of the actual value of money to a precarious borrower like Bogue during the relevant pe-

riod. Thus the first theory of damages upheld by the Circuit Court is entirely within the "out-of-pocket" rubric which petitioner concedes to be applicable to the instant case. That is reason enough to uphold the decision to give plaintiff his day in Court.

Plaintiff's second theory of damages, the cost to Bogue of obtaining the monies elsewhere, was held to be "the mirror image of the first", because "it looks to the seller's gain rather than the buyer's loss" (Pet. 13a). The second theory was held to be part of the "out-of-pocket" concept too, even though "disgorging" was part of its basis.

Plaintiff relied on *Upson* v. *Otis*, 155 F.2d 606 (2d Cir., 1946); *Fletcher's Cyclopedia of Corporations*, Section 1343 and *DiTomasso* v. *Loverro*, 293 N.Y.S. 912 (A.D. 2d, 1937), to support a searching inquiry into the value of money as a commodity to a defalcating corporate fiduciary in 1971. The question presented by plaintiff was: What would have been a proper interest rate in terms of what Belco would have demanded in an arms-length loan to Bogue at the time of these fraudulent loans, taking into account all the factors that a knowledgeable lender, aware of market conditions, and freely exercising its discretion, would bring to bear on such a substantial and risky business transaction with Bogue? Plaintiff asked merely that the Federal Court in a securities fraud case, but sitting in equity because fraud upon a corporation was involved, review the loan transaction with respect to a fair interest rate in a practical and businesslike manner. Cost of the money to Belco, risk, security, term, general money market conditions, and the unavailability of alternative financing to Bogue were all argued as being relevant to a just result on the first two theories of damages. Rather than resulting in a conflict with the Tenth Circuit decision in *Estate Counselling Service Inc.* v. *Merrill, Lynch, Pierce, Fenner & Smith*, 303 F.2d 527 (1962), the Second Circuit cited such decision in support of its analysis of actual value of

the commodity parted with by the victim of securities fraud (Pet. 12a). The underpinnings of the Second Circuit's Opinion herein are the very cases which petitioner claims to be in conflict therewith—*Janigan* v. *Taylor*, 344 F.2d 781 (1st Cir. 1964) cert. den. 382 U.S. 879 (1965), and *Myzel* v. *Fields*, 386 F.2d 718 (8th Cir., 1967). As will be seen *infra*, these decisions in other circuits were the basis of plaintiff's argument below and were adopted by the Second Circuit as sound precedents for analyzing the special facts of the instant case.

The Court of Appeals then turned to plaintiff's next claim (the "third theory", Pet. 13a), that there was a hidden profit to Bogue in the transaction which it should be required to disgorge. The hidden profit arose because Bogue pledged 150,000 shares of its subsidiary's stock with the subsidiary itself, as collateral for the loans of $315,000. As a result of being able to force this loan, which was a form of margin borrowing, upon the subsidiary corporation, Bogue was able to retain these 150,000 shares notwithstanding other grave financial pressures upon it. It was enabled to wait for a rise in the market value of these unregistered (under the Securities Act of 1933) and unliquid shares, which were difficult to pledge with an arms-length lender, and could only be sold as part of a total disposition of control in Belco. Such rise in market value occurred within a year, in the spring of 1972 (five months after this case was started), and Bogue was thus enabled to sell the 150,000 shares put up as collateral for $412,500 to Foster-Wheeler Corporation, as part of a disposition of all of its other shares in Belco which had not been pledged as collateral. This forced margin loan of $315,000 was valuable financing to Bogue for a profitable transaction, which Bogue, who was insolvent and in a severe liquidity crisis, could not otherwise have obtained. The difference between the $412,500 received for the 150,000 shares, and the $315,000 repaid to Belco for carrying them an additional year, was a net profit of $97,500 to the parent cor-

poration. The documentation presented to the Circuit Court showed that Belco, who was forced to accept the 150,000 shares as collateral, was the de facto owner of such shares from the date of pledge, because the parent's note was essentially uncollectible and they were the only realistic source of ultimate repayment. Plaintiff claims that Belco should have all the profit from the sale, because Belco's forced loan gave Bogue the breathing time, without a "distressed sale" of these shares (which being unregistered under the Securities Act of 1933 were not readily pledgeable). Bogue, with no genuine risk, could wait until Belco became profitable, and the parent thus obtained a handsome profit on the shares by placing the risk on the subsidiary. Plaintiff claims that the profit of $97,500 belongs to Belco, in addition to the realistic rate of interest described above. In sum, a trustee made a private profit on the trust estate, because it obtained margin financing that no broker or bank would give it. The trustee was like any other fiduciary converting the property of the trust estate, and required to disgorge his illegal profit. See *Upson* v. *Otis*, *supra*. There was no bargain with Belco as to which it was seeking the benefit, as was rejected in *Estate Counselling Service, Inc.* v. *Merrill, Lynch, etc.*, *supra*. There was only theft by a fiduciary and profit to him sought to be restored.

On this third theory of damages, the Circuit Court set forth strict elements of proof, requiring a showing that Belco was harmed, "that Bogue required the forced loan to keep alive, and that it had no other means of doing so except by selling, not pledging some of its Belco shares; and that an earlier sale would have resulted in a lower price for the stock". (Pet. 14a) Under this strict burden of proof (which plaintiff feels confident it can meet nonetheless), did the Court of Appeals establish a new theory of recoverable damages under the securities acts, and did it create a conflict among the Circuits by such theory, as petitioners contend?

An examination of the cases relied upon by the petitioners establishes that petitioners' claim of conflict in the Circuits, or novelty in Judge Friendly's theory, is wholly imaginary. In sum, petitioners argue that defrauded buyers of securities (such as Belco who was forced to take its parent's note and a pledge of its own stock to secure the uncollectible note) are not entitled to the same measure of damages as defrauded sellers. Sellers can recover future accretions to the property obtained by the fraudulent party, concede the petitioners, but it is claimed that buyers cannot recover such accretions. The theory must fall of its own weight, and shatters completely when measured by *Janigan* v. *Taylor*, *supra*, and *Myzel* v. *Fields*, *supra*, upon which petitioners themselves rely (Pet. 6).

Abuse of corporate trust relationships is well within Rule 10b-5 if deception in the use of securities is established. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1971). Does the rule of *Upson* v. *Otis*, *supra*, where the Second Circuit long ago stated both the Delaware and New York rules for damages recoverable from defalcating corporate fiduciaries, require any modification in the context of a Rule 10b-5 claim under the 1934 Act or a Section 17(a) claim under the 1933 Act? We submit that it does not, because it is well settled, even in Rule 10b-5 cases, that a defrauded seller of securities can recover not only the difference between the stated and the actual value of what he has received at the date of sale, "but added profits which the buyer has realized through accretions in value subsequent thereto." *Levine* v. *Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971). In the instant case there was an accretion in value to Bogue with each withdrawal because cash was worth so much more than its face value in 1970 and 1971. Moreover, Bogue admitted in its papers that it had prior offers for Belco's shares from 1971 onward and rejected them to pursue further speculative gain as Belco's profits increased—all at Belco's risk.

Proceeds which the seller (or lender of property) would have realized if it had retained the property for a reasonable period after the fraudulent transfer may be considered in determining the proper recovery. *Myzel* v. *Fields*, *supra* at pp. 744-747; *Janigan* v. *Taylor*, *supra* at p. 786, followed in the Second Circuit in *Levine* v. *Seilon, Inc.*, *supra*. The rationale for the favorable treatment of defrauded sellers of securities (or anyone "induced to *convey property* to the fraudulent party") was stated by Chief Justice Aldrich in *Janigan*, as follows:

> "It is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them . . . it is simple equity that a wrongdoer should disgorge his fraudulent enrichment." (p. 786)

Thus, in the context of sellers of securities, several circuits have applied fundamental equity principles of damages, applying the concept of unjust enrichment and recovery of the highest intermediate value of securities wrongfully obtained during the period of unlawful conversion. Moreover, *Janigan* v. *Taylor*, *supra* at p. 786, addressed itself to all sellers of property, not just to sellers of securities. See approval of *Janigan* in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972). Thus *Upson* v. *Otis*, *supra*, is already a part of the law of Rule 10b-5, and requires recovery of the private profit on sale of the collateral made by a disloyal fiduciary.

By taking the bare facts of the jurisdictional presentation in this case, i.e., that Belco "bought" Bogue's note and the shares of Belco stock deposited by Bogue as collateral, the petitioners wish to treat Belco solely as a "buyer" of securities and limit its recoverable damages on the transaction to the price paid for the securities, with interest at the 8% rate volunteered by the petitioners. This mechanical approach to the issue of the proper

measure of recovery, once federal jurisdiction has properly attached, is inappropriate. Even literal application of the phrase "out-of-pocket" meant some $400,000 to Belco because that was its net cost (after commissions and expenses) for $315,000 in cash through a public offering the year before, and the value of such assets had increased in 1971 because of "tight-money". Petitioners' approach forces the federal courts to ignore the realities of the money markets when it is money that has been misappropriated, rather than shares or timber or steel. See *Perlman* v. *Feldman*, 219 F.2d 173 (2d Cir. 1955) for recovery of the corporate opportunity to sell steel in the Korean War "grey market" implicit in the valuation of control shares sold at a substantial premium. *Perlman* applies both to the lost opportunity to earn a realistic interest rate herein (first and second theory), the profit diverted by Bogue by using Belco's money to finance margin borrowing on 150,000 shares of stock (third theory of damages), and the lost opportunity to earn a fair return on its cash capital, i.e., 40% was being earned in its normal business. (See fifth theory, *infra*.)

While Belco may have been a "buyer" of securities for jurisdictional purposes, for purposes of the practical business substance of its claim here, it was a "seller" of money. And it was a "seller" of money to a buyer with little ability to repay in a tight money market, who forced such sale by use of its control over an interlocking board of directors. Belco's announced business in its recent prospectus to the public did not include making high-risk loans to control persons. Belco said it was in the waste treatment business. A Federal court should not use a jurisdictional "buyer"-"seller" framework to evaluate the substantive rights of recovery for a plaintiff once he has made out his case showing deception and overreaching within the ambit of the federal securities laws. The Court, rather, should give just compensation for deprivation of property within the traditional framework of "simple

equity". *Janigan* v. *Taylor*, *supra*. The decision in the District Court had the anomalous result of making a misappropriation of cash more attractive to fiduciaries than removal of less liquid assets—8% per annum might be too good a deal for defendants like Bogue to pass up again.

Judge Friendly's decision states "We do not consider the . . . cases . . . establish any such bright line between defrauded sellers and defrauded buyers as defendants [petitioners] urge." (Pet. 11a). He then states the legal reality: "The reason why the remedy [disgorging wrongful profits] has been applied for the benefit of defrauded sellers but not of buyers is not any decisive legal difference but the difficulty generally confronting the defrauded buyer in showing that the fraudulent seller has in fact reaped such a profit." (Pet. 12a).

Even the cases cited by the petitioners go further in dealing with the substantive issues of recovery than petitioners claim. *Estate Counselling Service, Inc.* v. *Merrill, Lynch, etc., supra*, at p. 532, urged by petitioner, does not bar a plaintiff from recovery under Rule 10b-5 of customary damages for an intentional tort, i.e., damages which are naturally and proximately caused by the fraud. The case holds that the defendant "is bound to make good the loss sustained—such moneys as the plaintiff has paid out, with interest, and any other outlay legitimately attributable to the defendant's fraudulent conduct" (p. 533). The case barred recovery only of the plaintiff's anticipated profits on a proposed short term trading transaction with his stockbroker, which he never completed, treating this as the "expected fruits of an unrealized speculation," which are concededly unrecoverable. But Belco's earning a realistic interest rate, or earning 40% a year operating its own business was not an unrealized speculation—the forced loan to an expiring parent corporation was the speculation, a transaction not in the ordinary course of business, inadequately collateralized, and a very dangerous venture.

Bogue's earning $97,500 on the shares left with Belco was also a speculation by a forced margin loan; that transaction *was* realized but Bogue kept the profit. The Supreme Court decision in *Smith* v. *Bolles*, *supra* also relied on by petitioners, merely restricts recovery of damages to the natural and proximate consequences of the act complained of, a principle which would be carried out by application of the concept of unjust enrichment, and the conversion rule, in the instant case.

The issue tendered by petitioner is whether a Federal Court should consider a Rule 10b-5 case for securities fraud on a corporation only up until the point where damages in the securities transaction are shown, then close its ears to any further elements of damages recoverable because the securities transaction also involved overreaching by the directors.* In other words, defendants are arguing that the federal courts should not give complete and entire relief on a cause duly brought before them. *Pappas* v. *Moss*, 393 F.2d 865 (3rd Cir., 1968), and *Schoenbaum* v. *Firstbrook*, 405 F.2d 215 (2d Cir., 1968) are all contrary to such a limiting principle. The simplistic argument that all that left Belco's pocket was cash, and therefore $315,000 (plus 8% interest) is the limit of its recoverable damages, was the beginning and end of petitioners' case.

In the instant case it is evident that Belco was not voluntarily in the business of lending money and the defendants merely paying 8% per annum interest for the use of its money neither undid a serious violation of Rule 10b-5 nor put an end to its damages. We submit that in addition to Judge Friendly's Opinion herein, and *Janigan* v. *Taylor*, *supra*, the Eighth Circuit's reasoning in *Muzel* v. *Fields*, *supra* (followed in *Baumel* v. *Rosen*, 412 F. 2d

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* Valuing the cash at its actual cost and charging a realistic interest rate (first and second damage theories) would come within the purview of even this limiting rule.

571, 575 [4th Cir., 1969]), was dispositive herein. Petitioners erroneously urge that because Belco brought a cause of action into the federal court under Rule 10b-5 as a "buyer" of securities, it must retain such status throughout the action, with all its limitations, on into the final decree of relief, arguing that the federal courts will be flooded with corporate mismanagement cases (Is fraud merely mismanagement to petitioners?) unless the recoverable damages are restricted. But *Myzel* states that the "nature of the relief sought, not the statute which creates the right, determines the legal or equitable remedy" (p. 741). *Myzel* also indicates that although Belco may be a "buyer" under Rule 10b-5 and Section 17(a) of the 1933 Act, it is entitled to both equitable and legal relief to the fullest extent once it establishes its case on the issue of liability, citing the well-known principle in the field of securities regulation that: "The power to *enforce* implies the power to make effective the right of recovery afforded by the Act." *Deckert* v. *Independence Corp.*, 311 U.S. 282, 288 (1940); *Straley* v. *Universal Uranium & Milling Corp.*, 289 F. 2d 370, 373 (9th Cir., 1961). Equitable doctrines of restitution are well accepted in Rule 10b-5 cases, including Section 151 of the Restatement of Restitution, relied on in *Myzel* v. *Fields*:

> "Where a person is entitled to a money judgment against another because by fraud, duress or other consciously tortious conduct the other has acquired, retained or disposed of his property, the measure of recovery for the benefit received by the other is the value of the property at the time of its improper acquisition, retention or disposition, or a higher value if this is required to avoid injustice where the property has fluctuated in value or additions have been made to it." (cited at p. 743, *Myzel* v. *Fields*, *supra*) "Where fungibles such as corporate stock [or, we submit, ready cash during a period of tight money] have no ready

> market value and actually fluctuate in value, different measures or modified versions of the same theory become more appropriate." (*Myzel* v. *Fields*, *supra*, p. 745).

The out-of-pocket damage theory, urged by petitioners is neither disregarded nor restricted in *Myzel* v. *Fields*, *supra*, but the complicated tailoring of a corporate pocket is examined within the Court's broad power to give complete and full relief, implicit in the fusion of law and equity. The Eighth Circuit enunciated the applicable principle as follows:

> "When stock in a corporation has not figured in the markets, and there have been no sales or dealings therein, its actual value must be determined at the fair price which a person who desires to buy would be willing to pay, taking into consideration the orgiinal capital, how far there has been profit or loss in the business carried on, the assets and liabilities, the future prospects and everything that goes to affect the value of the shares of stock." (*Myzel* v. *Fields*, *supra*, p. 745).

By the same token, the value of working capital to a small start-up corporation which has recently gone public, which has recently paid $1.26 in cash and equity value for every $1 of this working capital raised from the public, and which is earning 40% per year for *all* shareholders, on its invested capital at the time of the forced loans, should be measured in equity by the same detailed analysis used for determining the value of any commodity at the time of wrongful deprivation. Thus, apart from determining a realistic interest rate, the instant case also has other damage elements in the private profit which a fiduciary obtained on trust assets (plaintiff's third theory) and loss of a 40% per annum internal corporate opportunity (fifth theory, Pet. 15a). In addition to *Upson* v.

Otis, supra, the federal courts have approved for decades a rule of damages for conversion of stock or other property measured by the price at the time of conversion or the highest intermediate value reached within a reasonable time after notice of the conversion, whichever is greater. *Galigher* v. *Jones* (cited in *Myzel, supra*), 129 U.S. 193, 200 (1889) states:

> "Other goods wrongfully converted are generally supposed to have a fixed market value at which they can be replaced at any time; and hence, with regard to them, the ordinary measure of damages is their value at the time of conversion, or, in case of sale and purchase, at the time fixed for their delivery. But the application of this rule to stocks would, as before said, be very inadequate and unjust."

In more recent years, the Supreme Court, in the famous decision where it instructed the Circuits to construe the federal securities laws flexibly, and not technically and restrictively, in order to effectuate their remedial purposes, commented:

> "There has also been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as advice and securities, and that, accordingly, the doctrines must be adopted to the merchandise in issue." (*S.E.C.* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 [1963].)

Myzel v. *Fields, supra,* and *Baumel* v. *Rosen, supra,* cite with approval the holding in *Janigan* v. *Taylor, supra,* that "it is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." The Second Circuit herein merely followed the unanimous views of the other Circuits who have considered these damage issues.

The authoritative treatises of *Bromberg* and *Loss* in the Rule 10b-5 field also support plaintiff's position herein, that the merchandise in issue must be intensively evaluated—what was money worth in general in 1970 and 1971 and in this particular context? Professor Bromberg's *S.E.C. Rule 10b-5*, at p. 227, after identifying the out-of-pocket rule applied herein for defrauded buyers, states that:

> "Prevailing defrauded sellers have done better by virtue of a constructive-trust approach, which gives them whatever profits the buyer has garnered on resale. This is plainly appropriate where the resale is immediate or under active contemplation, but is more doubtful, though still used, when the resale is much later and was not planned at the time of sale. Unless the fraud is relatively severe, a fairer measure would be the difference between the price and value at the time of the transaction, in symmetry with the buyer cases . . ."
>
> * * *
>
> "A defrauded issuer is not limited to cancellation of the securities or recovery of their par value, but may recover their fair value at time of issuance. By analogy to the seller cases, the issuer may be entitled also to post-issuance profits of the recipients." (pp. 227-229)

What this authority is saying is that the federal courts have authority to give a complete and full remedy for violation of the securities laws, whatever form such violation may take, and that no distinction should be made in framing a decree of relief as between someone who came into court, for jurisdictional purposes, as either a "seller" or "buyer" of securities. *Loss on Securities Regulation*, Vol. 6, p. 3923, takes essentially the same position on the measure of damages, stating that, for complaining sellers of securities where there is no market for the securities,

> "fair value is to be determined from all of the pertinent circumstances both for a reasonable time before the sale

> and after it . . . If there can be no exact calculation . . . the wrongdoer cannot complain if a reasonable approximation is reached." (citing *Ross* v. *Licht*, 263 F.Supp. 395, 410 [S.D.N.Y. 1967], and on the approximation point, *Gratz* v. *Claughton*, 187 F.2d 46, 51-52 [2d Cir., 1951])

Professor Loss then goes on to state:

> "Presumably the same measure of damages will be applied *e converso* in so far as *buyers* may be permitted to sue under Rule 10b-5 or Section 17(a) of the 1933 act (see *Janigan* v. *Taylor*, *supra*)."

Thus it appears there was no reason for the Second Circuit to make a distinction between Belco's status as a "buyer" of Bogue's note, or as an unwilling "seller" of Belco's working capital, in fashioning an appropriate measure of relief, consonant with established principles of restitution, value of a converted commodity (or diverted opportunity) and unjust enrichment, as historically enforced by the federal courts. Petitioners here have overlooked the traditional duty of a court of equity, in a Rule 10b-5 case or any other action, to fashion a remedy appropriate to the wrong committed.

The principles which govern herein are as ancient as those in *Oliver* v. *Piatt*, 44 U.S. 333 (1845). There a trustee misappropriated trust assets and involved them in other property. The original assets were later repurchased for return to the trust, but the beneficiary elected to trace the new more valuable property and was allowed to do so. The Court stated that the trustee should not be permitted to avail himself of his own wrong, and if he had made a profitable investment of the trust fund, to appropriate the profit to his own benefit by a repurchase of the trust fund, and to charge the loss or deterioration in value if any against the trust. The ancient rule in equity is "that all the gain made by the trustee, by a wrongful appropriation of the trust fund, shall go to the *cestui que trust*, and all the losses shall be borne by the

trustee himself." This case is cited in *Perkins* v. *Waukesha National Bank*, 290 F.2d 912 (7th Cir., 1961). For further applicable trust cases, see *Jefferson Savings & Loan Association* v. *Lifetime Savings & Loan Association*, 396 F.2d 21 (9th Cir., 1968). See also *Grodsky* v. *Sipe*, 30 F.Supp. 656, 661 (E.D. Ill. 1940), which states:

> "Among the obligations of any trustee . . . are those to use care and diligence in the discharge of his functions. For the failure to do so, he is liable even when no wrongful intent appears. He may be liable for neglect because answerable for property actually lost through want of care and prudence and for moneys which he might have received if he had exercised due care, prudence, and judgment in his dealings with the trust estate."

Finally, in a transaction where one party, Bogue, controlled both sides of the bargain, its subsequent volunteering of 8% per annum after a suit was prosecuted, is reason enough to see if the facts required a more substantial payment. Even the 8% per annum was not sufficiently proven, being shown only in an affidavit based on average outstanding balances, without any opportunity for plaintiff to make inquiry as to the validity of the computations.

The fourth element of damages herein seeks recovery of consequential damages in that a substantial public securities offering for the benefit of Belco was terminated in 1971, because of the improper overreaching of the insider defendants and the unwillingness of underwriters to sanction continuation of these improper loans in an underwriting for which they were being responsible. This element of damages to the corporation is of course a question of fact to be proven, and while the motion papers showed that such claim has substance, it should be evaluated in an overall hearing on damages. Judge Friendly required that plaintiff "must establish the causal nexus

with a good deal of certainty" (Pet. 14a), and further set out strict guidelines for any recovery on this damage theory (Pet. 15a). There is no reason why potential corporate growth from another public offering, forestalled by the overreaching of the defendants, should not be a recoverable item as against these fiduciaries. The growth of the company at a substantial rate each year is no different from the reasonable growth of any other trust fund, and plaintiff should have his day in court to show the underwriting negotiations, the nature of the proposed offering and that the underwriters refused to handle the transaction as a proximate result of these continuing loans to insiders of Belco. And further as required by the Circuit's Opinion, "that Belco could have used the proceeds in a manner which would have increased per share earnings" (Pet. 15a). In substance, plaintiff should have the right to prove as compensable damages under the 1933 and 1934 Acts that defendants' conduct violative of the securities laws and their fiduciary duties placed a definable, substantive cloud upon Belco's ability to raise money from the public, and prevented putting such money to productive use at or near the return on capital established for 1971. The Circuit established a similar tight rule of proof for plaintiff's fifth theory, of consequential damages for loss of the opportunity to earn this 40% per annum return on capital even on the $315,000 pulled out of the business by Bogue's overreaching (see Pet. 15a).

At bottom, the decision of the District Court had to be reversed by the Second Circuit because it made Rule 10b-5 a remedy which requires the courts to ignore economic reality and restrict their Rule 10b-5 judgments to legal interest on liquidated claims. When the violation of federal law occurs in the context of fiduciary duties, such a rule could not be allowed to stand.

CONCLUSION

The Petition for a Writ of Certiorari should be denied, because there is no conflict in the Circuits on the damage theories delineated by the Second Circuit, and the instant case goes no further than long established precedents applicable to securities fraud practiced upon a corporation by controlling persons. Petitioners were caught with their hands "in the till", and when they tried to replace the monies taken, they continued to take a selfish, short-sighted view of all the damage they had done to Belco, and all the profit they had reaped for themselves.

Respectfully submitted,

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MICHAEL RODAK, JR.,

IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-1616

BOGUE ELECTRIC MANUFACTURING CORPORATION, EDWARD P. SCHINMAN, ROBERT S. HERWIG, WILLIAM S. GUTTENBERG and MURRAY REIFFIN,

Petitioners,

—v.—

HERMAN L. ZELLER, IRWIN SMALL COMPANY, a Partnership, and BELCO POLLUTION CONTROL CORPORATION,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONERS' REPLY BRIEF

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Certiorari should be granted in view of the clear conflict between the Second and Tenth Circuits as to the proper measure of a defrauded buyer's recoverable damages under the federal securities laws *as applied to the facts below, notwithstanding Respondent's mistaken assertion that the alleged buyer for jurisdictional purposes in the instant case is really a seller of money for damage purposes* 15

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Certiorari should be granted in view of the clear conflict between the Second and Tenth Circuits as to the proper measure of a defrauded buyer's recoverable damages under the federal securities laws *as applied to the facts below, notwithstanding Respondent's mistaken assertion that alleged damages may be awarded in the instant case even though they are not a part of his actual damages on account of the federal jurisdictional act complained of* 17

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-1616

BOGUE ELECTRIC MANUFACTURING CORPORATION, EDWARD P. SCHINMAN, ROBERT S. HERWIG, WILLIAM S. GUTTENBERG and MURRAY REIFFIN,

Petitioners,

—v.—

HERMAN L. ZELLER, IRWIN SMALL COMPANY, a Partnership, and BELCO POLLUTION CONTROL CORPORATION,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONERS' REPLY BRIEF

Justification for Reply Brief

Petitioners seek a Writ of Certiorari to gain review of an erroneous decision of the United States Court of Appeals for the Second Circuit which overcame a clear jurisdictional defect in the record below by deciding an important federal question in a way in conflict with applicable decisions of other Circuits which have relied upon early decisions of this Court.

That important federal question is whether under §28(a) of the Securities Exchange Act which limits recovery to "actual damages on account of the act complained of,"

an allegedly defrauded buyer, whose out of pocket loss has been fully recompensed may also recover such non-out of pocket items as lost profits, gains prevented and consequential damages (Pet., p. 2).

In an unprecedented departure from settled federal law, the Second Circuit approved such an expansion of recoverable damages, reversing the District Court's contrary holding (See Pet., p. 21a).

Nowhere in Respondent's Brief in Opposition, except for the formal wording of its "Point I," does Respondent challenge Petitioners' contention that there is a clear conflict between the Circuits and that the Second Circuit changed the federal measure of recoverable securities fraud damages. Instead, Respondent's Opposing Brief introduces new matter in an attempt, exclusively, to argue that *special facts* in the record below reduce the conflict between the Circuits to a conflict *in principle* rather than a conflict *in holdings,* asserting that the instant case *on its facts* justifies an expanded measure of damages for any of three reasons:

1. that there still exists an unrecovered out of pocket loss, bringing the case *within* the out of pocket rule for defrauded buyers (Brief in Opp., pp. 4-6); or
2. that Respondent is really a defrauded seller for damage purposes, taking the case *out of* the out of pocket rule for defrauded buyers (Brief in Opp., pp. 10-12); or
3. that Respondent may be awarded the damages requested since federal jurisdiction has been allegedly shown, even though such damages are not a result of the federal jurisdictional act complained of, ren-

dering the out of pocket rule for defrauded buyers *irrelevant* where there are state fraud damages also claimed (Brief in Opp., p. 13).

To support such assertions, Respondent recites interpretations of the record below that are highly inaccurate and at times scandalous, seeking to confuse the factual foundation of the case, thereby weakening Petitioners' chances of securing review (See Appendix D, p. 1a).

The purpose of this Reply Brief is to respond to Respondent's distortion of the record by a clear showing that there are no operative special facts below that reduce the conflict between the Circuits to merely one in principle.

Respondent has felt free to take liberties with the facts below where no party to this action has heretofore requested that the record be certified to the Court. Accordingly, Petitioners have requested, on September 21, 1973, that the Clerk of the Court of Appeals for the Second Circuit prepare and certify for transmission to the Clerk of the Court a copy of the entire record below.

Petitioners pray that the Court will consider this Reply Brief as well as the record below, and accept their submission as timely under applicable Court Rules. Upon the filing of Respondent's Brief in Opposition, Petitioners have changed legal counsel, causing a slight delay in Petitioners' reply.

The federal question in this case is an unusually important one which will have a significant impact throughout the nation. At least one-third of all federal securities cases are now 10b-5 actions; 1 Bromberg, *Securities Law, Fraud, S.E.C. Rule 10b-5*, §2.5(6). Of these, few are ever

tried, the proportion of settlements being quite high; *Id.*, Volume 2, at §9.1. The Second Circuit's decision below is likely to make such settlements more difficult to achieve in the future, since the parties in 10b-5 actions will have a more difficult time ascertaining the probable worth of future cases under uncertain and expansive damage rules.

In addition to serious issues of federal congressional intent, the decision below raises complex questions concerning the proper allocation of federal judicial resources and the proper relationship between federal and state antifraud provisions of securities laws which only the Court can and should answer. These matters have not been considered by the Court since 1900, and never in connection with contemporary federal securities laws. See *Smith* v. *Bolles*, 132 U.S. 125, 129 (1889); *Sigafus* v. *Porter*, 179 U.S. 116, 123 (1900).

The facts in the instant case warrant and make possible such a review this coming Term, notwithstanding Respondent's misrepresentation of the facts below (which this Reply Brief corrects).

Correction of Record Below

In this action based on allegations of fraud, Counsel for Respondent has—rather paradoxically—sought to gain benefits throughout this litigation by *misrepresenting* the facts of this case. As trial counsel for Petitioners has previously justifiably protested in the District Court, "Plaintiff's papers . . . attempt, by the use of psychologically loaded words and false, slippery reasoning and deliberate distortions and misrepresentations, to demonstrate such

equities in plaintiff's favor and such misconduct on defendants' part as to blind the court to the actual facts" (Stone Reply Affidavit, para. 3, p. 2).

Respondent's Brief in Opposition is no exception. It is a jumble of misstatements, often incorrect, occasionally scandalous, and even seeks to have the Court believe that Petitioners have conceded gross fraud (Brief in Opp., p. 4), an assertion totally without one syllable of support in the record below. Since this is not yet a proceeding on the merits, Petitioners wish to demonstrate Respondent's misrepresentations in appendix form (see Appendix D, p. 1a) at least to put them on the record.

However, since Respondent has made an issue out of the facts, as they relate to Petitioners' chances of gaining review by this Court, Petitioners seek to clarify the facts below and therefore summarize the record which has been certified to this Court, as follows:

The relevant facts in this action have occurred in six stages.

Stage I: Belco Created by Bogue and Incorporated

Belco began as a mere division of Bogue's business. It was incorporated as a separate entity in 1968, and wholly controlled by Bogue until late 1968 when through a public offering of Belco stock Bogue's control was reduced to approximately 75%. Bogue controlled the management and growth of Belco and had the most to gain by Belco's success, until May 1972 when Bogue sold its controlling shares in Belco to Foster-Wheeler. Both corporations during that period occupied space at Bogue facilities. Both corporations worked jointly on mutually advantageous business

ventures. Belco, in particular, received numerous benefits from its close association with its parent corporation (Guttenberg Affidavit, paras. 4-8, pp. 2-3).

Stage II: Intercompany Accounts

Beginning as early as 1968, Bogue and Belco established intercompany accounts to record financial transactions between them. These accounts were *not* started to effect intercompany loans. Belco had no manufacturing capability. Bogue was its major supplier and co-contractor on many projects. The intercompany accounts were necessary for intercompany *business* transactions. Credits or debits in such accounts did not represent intercompany borrowings in fact until the second half of 1970. Before then, the intercompany account was mostly in Bogue's favor, Belco owing Bogue often over $100,000 without any interest charges. Belco, on the other hand, was always credited with 8% interest on amounts owed to it by Bogue (Guttenberg Affidavit, paras. 9-16, pp. 3-7).

Stage III: Collateralization and Repayment of Intercompany Loans

During the first half of 1971 amounts owing Belco by Bogue in the intercompany accounts increased significantly, for the first time exceeding $300,000. This amount being unanticipated by Bogue, Bogue management moved responsibly to secure repayment by executing a promissory note in favor of Belco, at the rate of 8% interest, effective July 1, 1971, secured by 150,000 shares of Belco stock owned by Bogue, and proceeded to make repayment of the amounts owing to Belco, with full 8% interest, during the next ten months. When Bogue's Belco stock was sold to Foster-

Wheeler in May 1972, the entire intercompany account was paid off by Bogue (Reiffin Affidavit, paras. 7-10, pp. 2-4).

Stage IV: Zeller Derivative Stockholder Charges

Coincidentally with a management decision by Bogue and Belco to allow an underwriter's right of first refusal (on any future public offering of Belco stock) to expire, a Belco shareholder of .037% of Belco shares brought suit in the Southern District of New York, alleging state and 10b-5 securities fraud. No effort was made by Plaintiff Zeller to take any discovery proceedings to obtain evidence.* Defendants, however, openly volunteered all relevant information and documents. As soon as Plaintiff Zeller learned of the repayment of the loan, Plaintiff moved for summary judgment and an award of attorneys' fees for its "contribution" in securing repayment. Plaintiff's supporting papers adduced no evidence, but voluminous rhetoric in an attempt to fabricate elements of a 10b-5 action. (See Brief for Appellees in the United States Court of Appeals for the Second Circuit, pp. 3-9.)

Stage V: District Court Proceedings

The District Court denied Plaintiff's motion for summary judgment, and instead granted summary judgment on behalf of Defendants (Pet., Appendix B, pp. 17a-22a). Judge Gurfein, having considered all issues in the case and all evidence in the record, handed down a short opinion which fused facts and law pertaining to the issue of damages. First, he concluded that federal law required a

* The Complaint in this action was based mostly on information and belief. Respondent's failure to place evidence in the record is noteworthy.

showing of out of pocket loss. Second, he concluded that Plaintiff had not substantiated the existence of any triable issue concerning out of pocket loss in relation to the underwriting, the use of the money otherwise in Belco's business, or the interest on the promissory note. (The open account was not considered to be the jurisdictional equivalent of a "security"; hence Judge Gurfein looked only to an out of pocket loss in connection with the note; *id.*, p. 18a.)

Stage VI: Court of Appeals Proceedings

The Court of Appeals also experienced Respondent's style of advocacy: "this is an ugly case . . . ; a corporation was robbed and the malefactors put the money back after they were caught" (Reply Brief for Appellant in the Court of Appeals, p. 24). The Court of Appeals ignored Judge Gurfein's implicit findings of fact in support of his granting of summary judgment, appearing to get lost in Respondent's rhetoric, holding that no matter how remote the chances of proving actual damages, "the judge should have allowed him to try" (Pet., p. 15a). In order to reach this result, the Court of Appeals committed reversible error:

1. The Court of Appeals ignored the substantial evidence in the record in support of Judge Gurfein's conclusion that no out of pocket loss was reasonably at issue below. Petitioner had argued for summary judgment *on the facts* as well as the law.* Although Judge Gurfein's opinion is admittedly terse, in the interests of justice, any close reading of the opinion

* Petitioners (Defendants below) had moved for summary judgment *or* an order dismissing the complaint for want of subject matter jurisdiction pursuant to Federal Rule of Civil Procedure 12(h)(3). The District Court granted the motion for summary judgment (Pet., pp. 19a, 22a).

will confirm that Judge Gurfein's references concerning *loan liability at common law* and *only the amount of the loan leaving Belco's "pocket"* at the conclusion of his opinion were directed not to the issue of fair interest (recovery #1 of the Court of Appeals' opinion) but to the issue of investment in Belco's business (recovery #5 of the Court of Appeals' opinion). See Pet., pp. 21a, 22a, 10a, 11a. Judge Gurfein seemed to assume that the fair interest rate for a loan was a part of the loan, in all essential respects, when the issue was repayment. See his statement, Pet., at 20a: "Bogue then repaid the entire amount owing to Belco with interest at 8%, more than the 7¼% claimed in the complaint." This reading of his opinion is consistent with the fact that Respondent below was claiming 40% interest based on Belco's rate of profit, although the record showed Belco's actual rate of profit on its capital was around 7½% (Guttenberg Affidavit, para. 18). Surely, a trial judge can conclude that there is no issue of fact relating to such a claim. For instance, can there be any doubt that, if Bogue had paid ½% interest on the loan (instead of 8%), Judge Gurfein would have ruled that there was a triable nonrecompensed out of pocket loss? Hence, it would be in error to read Judge Gurfein's opinion as purely a determination on the law of out of pocket loss. It must be read as a finding of fact on the claim of interest advanced by Respondent below. With evidence in the record to justify his decision *on the facts*, the Court of Appeals' substitution of its judgment for his in the procedural posture of this case was reversible error.* Moreover, the Court

* Respondent's Complaint was based principally on information and belief; yet, Respondent initiated no discovery below.

of Appeals, in its opinion, justifies an inquiry on the fair rate of interest because of Bogue's alleged precarious financial condition, ignoring the evidence in the record to the contrary upon which the judgment below must necessarily have been based, and ignoring the substantial collateral which accompanied the loan and the sufficiency of which is now moot.

2. The third theory of recovery identified by the Court of Appeals (profit from Bogue's pledged shares of Belco stock later sold to Foster-Wheeler) goes beyond mere out of pocket loss, and was not even argued below in the District Court.

3. The fourth and fifth theories of recovery mentioned by the Court of Appeals were rejected *on the facts* by the District Court as "speculative" and "conjectured" respectively. The record is devoid of any reason to believe otherwise. It is true that the Court of Appeals has announced a very stiff burden of proof for Respondent in the trial of these issues, Pet., at 14a and 15a, and did "not take a very bright view of plaintiff's prospects on his fourth and fifth issues," *Ibid.*, yet is this not what the out-of-pocket defrauded-buyer rule is designed to avoid—a trial on remote facts with the chances of recovery dim and the consumption of court and litigant resources glaring? Especially in situations where there is no out of pocket loss, as Judge Gurfein ruled in this case, must consequential damages be tried anyway?

4. The Court of Appeals reached out to consider general questions of damages it desired to discuss as if writing a law review article hypothesizing with the aid

> of our facts in the instant action *entirely on the basis of Respondent's complaint and moving affidavit.* In doing so, in order to justify its approaches, it ignored the full record before the District Court *on motion for summary judgment.* Surely, a District Court need not give equal weight to rhetoric and fact in passing upon a motion for summary judgment.

Not only, therefore, did the Court of Appeals announce new law. It did so squarely on the actual facts of this case, upsetting the District Court holding, although it contended it was doing otherwise: "Although most of plaintiff's theories do not involve that issue [of expanded buyer's recoveries] and the ones that do may fail on different grounds, we think it desirable to state our views since the question is fairly raised" (Pet., at 11a).

There are serious questions in this litigation concerning the Court of Appeals' scope of review. The undisputed facts in this case, however, whatever scope of review is employed, place the Court of Appeals' holding in clear conflict with that of the Tenth Circuit for the following additional reasons below:

COUNTER-REASONS FOR GRANTING THE WRIT

The following three points are in response to new matter raised in Respondent's Brief in Opposition. They are numbered in sequence with the first three arguments presented in the Petition.

POINT IV

Certiorari should be granted in view of the clear conflict between the Second and Tenth Circuits as to the proper measure of a defrauded buyer's recoverable damages under the federal securities laws *as applied to the facts below, notwithstanding Respondent's mistaken assertion that the alleged out of pocket loss in the instant case has not been fully recompensed.*

Respondent attempts to side-step the clear conflict between the Circuits pointed out in the Petition (p. 5), which is never directly challenged by Respondent, by asserting that the instant case comes *within* the out of pocket damage rule (Brief in Opp., p. 4). In order to argue this position, Respondent is forced to confuse the actual facts of this case and blur significant distinctions manifest throughout the record below.

Respondent lumps together intercompany open account borrowing occurring before July 1, 1971, and the collateralized note, in asserting that the amount of money Belco parted with was of greater value than the 8% paid by Bogue for use of Belco's money *from 1970 through 1972*. Yet, the Court of Appeals held that the threshold federal issue relates, for purposes of review, *only* to the worth of

the collateralized note and not the open account. Hence, Respondent's burden here is to demonstrate that the note issued on July 1, 1971, caused Belco an out of pocket loss "on account of the act complained of" to bring these facts under the out of pocket loss rule.

However, since all moneys owed to Belco by Bogue had by July 1, 1971, been paid to Bogue on open account, consideration for the note was actually cancellation of the open account which was then bearing 8% interest (the interest also supplied in the note). Any wrongdoing in connection with the loans previously made, which would have required an interest rate in excess of 8%, is not attributable to the making of the note, for which no actual money was paid. Indeed, Respondent incessantly contends throughout this litigation that at the time of the making of the note the open account loans were worthless, suggesting that, if anything, Belco got a greater rate of interest (8%) for the open account loans than the marketplace would have justified (Complaint, para. 10, p. 6).

The flaw in Respondent's reasoning is that, rather than a part of any *plan to defraud* Belco, no other interpretation of the record is justified than that the July 1, 1971, note was a part of a *plan to repay* the open account loans. It would be ironic, indeed, to punish Petitioners for attempting to secure the loans to Belco, when such acts surely should be encouraged by the federal securities laws.

The Court of Appeals thought that Respondent should be allowed to try this issue for the only expressed reason that it was alleged that Bogue had a precarious financial condition during a tight money period (Pet., p. 10a). Yet, the note in issue was supported by *substantial* collateral which

as a matter of law refutes assertions of insecurity. (There is some dispute in the record over the exact worth of the collateral, but agreement on its substantiality.) Since the full amount of the note was repaid with full interest and the value of the collateral actually exceeded the loan, any dispute over sufficiency of collateral is clearly moot.

Since Section 28(a) of the Securities Exchange Act of 1934 mandates a showing of "actual damages on account of the act complained of" (Pet., p. 24a), Respondent's clear inability to show damage to Belco by the making of the collateralized note in the circumstances of this case, such note actually conferring a benefit upon Belco for securing existing indebtedness, requires as a matter of law the dismissal of this action for the reasons and authorities given by the District Court (Pet., pp. 20a-21a). The Court of Appeals' decision to remand this case for trial on this issue is erroneous and clearly in opposition to the result Petitioners would have obtained in the Tenth Circuit. See *Estate Counseling Service, Inc.* v. *Merrill Lynch, Pierce, Fenner & Smith*, 303 F.2d 527 (10th Cir. 1962).

POINT V

Certiorari should be granted in view of the clear conflict between the Second and Tenth Circuits as to the proper measure of a defrauded buyer's recoverable damages under the federal securities laws *as applied to the facts below, notwithstanding Respondent's mistaken assertion that the alleged buyer for jurisdictional purposes in the instant case is really a seller of money for damage purposes.*

Respondent again attempts to escape the argument that there is a clear conflict between the Circuits, advanced by Petitioner (Pet., p. 5), by asserting that the facts in the instant case are "special" and show Respondent to actually be a seller of money, the "practical business substance of its claim" (Brief in Opp., p. 11).

This view, of course, is what *Petitioners* have tried unsuccessfully to argue in the Court of Appeals *as it relates to the issue of there being no security in the case for federal jurisdictional purposes.* If Respondent were a mere lender under a promissory note, a seller of money, it would seem that no security in any meaningful sense would in fact exist, unless perhaps until the note were transferred to a third party, who would then be buying a "security" with a fluctuating value in the commonly understood use of the term.

The Court of Appeals, however, held that Respondent was an "investor" and not a "lender" under federal law, for reasons that were not expressed: "It does not follow, however, that every transaction within the introductory clause of §10, which involves promissory notes, whether of

less or more than nine months maturity, is within Rule 10b-5. The Act is for the protection of investors, and its provisions must be read accordingly. . . . But we see no reason to doubt that Belco stood in the position of an investor, although perhaps an involuntary one, with respect to Bogue" (See Pet., p. 9a).

Respondent cannot have it both ways. The determination of Respondent as an "investor" for jurisdictional purposes carries substantive and not mere semantic weight. For that distinction runs consistently throughout the relevant statutes and the case law in reflecting differing damage postures and private recovery policies. True, a defrauded buyer of a security is in a sense a defrauded seller of what he gave in exchange—usually money, but this claim would be self-defeating as far as the federal securities laws are concerned. The 1933 Act affords remedies to buyers only. The 1934 Act benefits both buyers and sellers, but §3(a)(10) in defining a security, specifically excludes "currency" (15 U.S.C. §78(c)(a)(10)). The distinction has also been treated as one of substance by every court which has considered it, except in the decision of the Court of Appeals below. See *Janigan* v. *Taylor*, 344 F.2d 781 (1st Cir. 1965), *cert. denied*, 382 U.S. 879 (1965); *Levine* v. *Seilon*, 439 F.2d 328 (2d Cir. 1971); *Myzel* v. *Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); compare with *Smith* v. *Bolles*, 132 U.S. 125 (1889).

Respondent's argument also falls because the consideration for the promissory note at issue was not money but cancellation of the open account, which was the result of loans previously made, and according to Respondent, the open account was worthless at the time of the note (July 1,

1971) due to Bogue's alleged insolvency: "During the six months ended June 30, 1971, the individual defendants caused Belco to make additional loans to Bogue aggregating to the sum of $315,310 as of June 30, 1971 . . . Plaintiff is informed and believes that the loans . . . are in jeopardy and probably uncollectible" (Complaint, para. 10, p. 6).

POINT VI

Certiorari should be granted in view of the clear conflict between the Second and Tenth Circuits as to the proper measure of a defrauded buyer's recoverable damages under the federal securities laws *as applied to the facts below, notwithstanding Respondent's mistaken assertion that alleged damages may be awarded in the instant case even though they are not a part of his actual damages on account of the federal jurisdictional act complained of.*

Respondent complains that Petitioners would permit a federal court to "consider a Rule 10b-5 case for securities fraud on a corporation only up until the point where damages in the securities transaction are shown, then close its ears to any further elements of damages recoverable because the securities transaction also involved overreaching by the directors" (Brief in Opp., p. 13). This, like so many other charges by Respondent, is not true.

Actually, Petitioners challenge the Court of Appeals ruling concerning damages for lost profits, gains prevented, and consequential damages (to be awarded in an appropriate case *in addition to* out of pocket damages) because in this case the evidence is and always has been conclusive

that no actual damages in the securities transaction occurred—that is, no out of pocket loss attributable to the making of the promissory note for 8% in exchange for the open account loans.

What Respondent is actually arguing is the position unsuccessfully advanced in the Court of Appeals in Respondent's Brief for Appellant (p. 43) that the federal courts may go on to award state law damages even if federal securities claims are dismissed on jurisdictional grounds—which the District Court, denying federal jurisdiction in the case, refused to do. This accounts for Respondent's repeatedly asserting that the special facts of this case will permit expanded damages without reference to the applicability of the out of pocket damage rule (thus avoiding a conflict between the Circuits). For example:

1. "The fiduciary obligation of the defendants under common law . . . were fused with the normally recoverable damages for violation of the federal securities laws" [referring to the Court of Appeals' decision] (Brief in Opp., p. 4).

2. "Abuse of corporate trust relationships is well within Rule 10b-5 [concerning recoverable damages]" (Brief in Opp., p. 9).

3. "a plaintiff . . . [may] recover under Rule 10b-5 . . . customary damages for an intentional tort, i.e., damages which are naturally caused by the fraud" (Brief in Opp., p. 12).

4. "the traditional duty of a court of equity, in a Rule 10b-5 case or any other action, to fashion a remedy appropriate to the wrong committed" (Brief in Opp., p. 18).

The above expansive damage theories, while appropriate to state law claims (Pet., p. 10), have never been permitted in the federal courts to be applied to alleged defrauding sellers as federal damage measures or for the enforcement of state law claims where no federal fraud jurisdiction was found to exist. For the limits of pendent jurisdiction, see *United Mine Workers of America* v. *Gibbs*, 383 U.S. 715, 726, 727 (1966). The reason is statutory: Failure to show "actual damages on account of the act complained of" in 10b-5 actions is a fatal jurisdictional defect which state law claims cannot cure. See *Estate Counseling Service, Inc.* v. *Merrill Lynch, supra*, 303 F.2d 527, 533; *Smith* v. *Murchison*, 310 F. Supp. 1079, 1084 (S.D.N.Y. 1970); *Commerce Reptg. Co.* v. *Puretec, Inc.*, 290 F. Supp. 715, 719 (S.D.N.Y. 1968); *Cohen* v. *Colvin*, 266 F. Supp. 677, 683 (S.D.N.Y. 1967); and cases cited in Petition, at 6.

Respondent, in calling attention to "special facts" showing alleged mismanagement, fiduciary abuse, and trustee wrongdoing, unintentionally is calling the Court's attention to the central thread of this case: that the essential acts of which Respondent complains concern the open account intercompany borrowings entirely which have been held by the Court of Appeals as not involving a security within the meaning of the 1934 Act (Pet., p. 9a). Respondent's remedy is to bring his action in an appropriate state court, rather than seek a wrenching of federal damage rules. This argument has already been made in the Petition, pp. 10-12.

For Respondent to secure federal relief *on the facts of this case*, the Court of Appeals below had to change 10b-5 damage rules, placing its decision in conflict with those of other Circuits.

CONCLUSION

For the reasons given in the Petition, and in this reply to Respondent's Brief in Opposition, Petitioners pray that the Writ be granted and that the erroneous decision of the Court of Appeals below be summarily reversed *or* that Petitioners be heard on the merits of the case.

Respectfully submitted,

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Attorney for Petitioners

September 25, 1973

APPENDIX

APPENDIX D

Respondent's Factual Assertions in Its Opposing Brief Compared With Actual Factual Contents of the Record Below

RESPONDENT'S FACTUAL MISREPRESENTATIONS	Nature of Assertion	ACTUAL FACTS FOUND IN RECORD BELOW
1. "the single issue in this case is the measure of recoverable damages" (Brief in Opp., p. 1)	misleading and incorrect	1. Petitioners deny fraud or wrongdoing of any kind; and assertion referring to "this case" suggests that only issue of extent of damages remains. (See Guttenberg Affidavit in Opposition to Motion for Summary Judgment for Resp.)
2. "forced loans . . . at unreasonably low interest rates, at a time when the parent was virtually insolvent and unable to borrow elsewhere, . . . for inadequate compensation, unconscionable profits" (Brief in Opp., p. 1)	misleading and incorrect	2. Respondent's rhetoric was completely refuted in pretrial affidavits, which were never answered by Respondent, although Respondent's rhetoric seeks immortality. (Compare Guttenberg Affidavit with Reply Affidavit of Lawrence Powers, regarding Motion for Summary Judgment)
3. "the parent borrower was virtually insolvent at the time [1970 through 1972]" (Brief in Opp., p. 2)	misleading and incorrect	3. Bogue financial statements refuted this charge. (Para. 3, Reply Affidavit of Guttenberg, never refuted by Respondent)

RESPONDENT'S FACTUAL MISREPRESENTATIONS	Nature of Assertion	ACTUAL FACTS FOUND IN RECORD BELOW
4. "there was no corporate purpose of Belco to be served by the loans" (Brief in Opp., p. 2)	misleading and incorrect	4. Numerous financial advantages to Belco were noted by Petitioners (below); the now-famous reference to the "corporate purposes of Bogue" recital in Belco's loan resolutions was merely inadvertent. (Reiffin Affidavit, paras. 17, 18, 19)
5. "Belco was earning some 40% per annum return on capital" (Brief in Opp., p. 2)	misleading and incorrect	5. Actually under 7½%. (See para. 18, Guttenberg Affidavit)
6. "Belco . . . had better use for the $315,000 in cash working capital in its own business" (Brief in Opp., pp. 2-3)	misleading and incorrect	6. Management of Belco thought otherwise, for good business reasons, while Respondent offers opinion without single fact. (See Guttenberg Affidavit, referenced by Court of Appeals, Pet. 15a, footnote 12)
7. "parent was using the forced financing . . . [for] the speculative carrying of the parent's 75% stock interest in Belco" (Brief in Opp., p. 3)	misleading and incorrect	7. Not one fact in the record to support this assertion; the contrary is proven by Bogue's other assets. (See Reply Affidavit of Guttenberg, para. 4)

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RESPONDENT'S FACTUAL MISREPRESENTATIONS	Nature of Assertion	ACTUAL FACTS FOUND IN RECORD BELOW
8. "virtually a weekly 'dipping into the till' of Belco by its parent whenever cash was needed in 1970 and 1971" (Brief in Opp., p. 3)	misleading and incorrect and scandalous	8. Intercompany transactions between co-contractors and manufacturer and supplier conducted in businesslike manner; went both ways, with Bogue making frequent payments to Belco (and at times Belco, to Bogue); Respondent's reading of ledger sheets supplied by Petitioners (below) shown to be erroneous. (Guttenberg Affidavit, paras. 6-16)
9. "fraudulent corporate 'window dressing' to conceal the abuse of control and misleading filings with . . . [S.E.C.]" (Brief in Opp., p. 3)	misleading and incorrect	9. Common accounting practices followed; effort to involve accountant in alleged fraud shown to be baseless. (Compare Powers and Small Affidavits Re Small's Cross-Motion for Summary Judgment)
10. "When sources of public financing discovered the . . . loans in 1971, a $1,500,000 equity financing . . . was cancelled" (Brief in Opp., p. 3)	misleading and incorrect	10. There was no such financing capable of being cancelled. (Reiffin Affidavit, paras. 23-25; Guttenberg Affidavit, para. 27)
11. "When the plaintiff's stockholder derivative action was brought . . . , Bogue was forced to seek methods for immediate repayment of the loan" (Brief in Opp., p. 3)	misleading and incorrect	11. There is no evidence of any sort to support this conclusion in the record, vital to Respondent's theory of a windfall recovery in attorney fees. This assertion was accordingly rejected by the Court of Appeals. (Pet. 16a)

RESPONDENT'S FACTUAL MISREPRESENTATIONS	Nature of Assertion	ACTUAL FACTS FOUND IN RECORD BELOW
12. "Bogue was required to pay back the forced loan at the closing of the proceeds of sale [to Foster Wheeler]" (Brief in Opp., p. 3)	misleading and incorrect	12. The repayment was only a result of the common practice of paying obligations out of the proceeds; it was not a requirement. (Guttenberg Reply Affidavit, para. 5)
13. "Bogue, on the verge of insolvency, with all credit lines exhausted and several items of corporate debt in default, had no other means of repaying the loans except from the proceeds of sale" (Brief in Opp., p. 3)	misleading and incorrect	13. The contrary is proven in the record. The issue is raised by Respondent (below), answered by affidavit, and never resubstantiated. (See Zeller Affidavit, p. 12; Guttenberg Affidavit, para. 17; Powers Reply Affidavit (no reply))
14. "gross fraud upon Belco, virtually conceded in the relevant documents" (Brief in Opp., p. 4)	misleading and incorrect	14. No gross fraud or any degree of fraud is conceded, "virtually" or otherwise, anywhere in the record below. (See, e.g. Reiffin Affidavit, paras. 7, 27)
15. "a note and . . . collateral to secure the note . . . was an integral part of a plan of fraud and deceit" (Brief in Opp., p. 4)	misleading and incorrect	15. The loans complained of were all made to Bogue before the making of the collateralized note, which was given for securing the repayment in aid of the creditor Belco. The record discloses no evidence of a plan of fraud and deceit.

RESPONDENT'S FACTUAL MISREPRESENTATIONS	Nature of Assertion	ACTUAL FACTS FOUND IN RECORD BELOW
16. "Bogue had exhausted its borrowing powers by 1971, measured by any businesslike standard" (Brief in Opp., p. 5)	misleading and incorrect	16. Bogue actually had an excess of current assets over current liabilities of nearly one and one-half million dollars, New Jersey and Canada real estate with more than eight million dollars of equity value, and over one million dollars in stock holdings; nearly eleven million dollars total assets (unencumbered equity balances) to support new borrowing. (Guttenberg Affidavit, para. 17; Guttenberg Reply Affidavit, paras. 3, 4)
17. "The facts presented to the Court below included the high cost of borrowing in 1970, with corporations paying effective interest rates of 15% to 20% per annum" (Brief in Opp., p. 5)	misleading and incorrect	17. Actually, no reliable evidence of this nature was presented. All that the record discloses is Respondent stating that "on personal experience" (without qualification as an expert) interest rates were 10% to 12% and effectively as much as 15% (considering equity sweeteners)—not 20%. (Zeller Affidavit, p. 11)

RESPONDENT'S FACTUAL MISREPRESENTATIONS	Nature of Assertion	ACTUAL FACTS FOUND IN RECORD BELOW
18. "there was . . . theft by a fiduciary" (Brief in Opp., p. 8)	incorrect and scandalous	18. Such statements would be actionable but for their privileged status in a legal proceeding. There is no evidence in the record that justifies such abusive statements. Such statements should be stricken from the record and discouraged.
19. "Bogue admitted in its papers that it had prior offers for Belco's shares from 1971 onward and rejected them to pursue further speculative gain as Belco's profits increased—all at Belco's risk" (Brief in Opp., p. 9)	misleading and incorrect	19. It is admitted only that Bogue had prior offers; the reason for not selling prior to 1972 is not stated in the record, and no admission concerning speculative gain relating to Belco profits was ever made by Bogue, notwithstanding the phraseology carefully employed by Respondent. (See Guttenberg Reply Affidavit, para. 4)
20. "even literal application of the phrase 'out of pocket' meant some $400,000 to Belco because that was the net cost (after commissions and expenses) for $315,000 in cash through a public offering the year before" (Brief in Opp., p. 11)	misleading and incorrect	20. The underwriting costs by express terms were paid by the public and not Belco. (Brief for Appellees Before the Court of Appeals, p. 16)

RESPONDENT'S FACTUAL MISREPRESENTATIONS	Nature of Assertion	ACTUAL FACTS FOUND IN RECORD BELOW
1. "[Bogue] subsequently volunteering of 8% per annum after a suit was prosecuted, is reason enough to see if the facts required a more substantial payment" (Brief in Opp., p. 19)	misleading and incorrect	21. Bogue did not volunteer 8% after suit was brought. 8% interest was paid by Bogue to Belco on the open account more than one year before suit was brought, and six months before suit was filed 8% was listed in July 1, 1971 promissory note. It is very difficult, indeed, to understand the charge that 8% was volunteered after suit when the factual record is consulted. (See Guttenberg Affidavit, para. 15; Levy Affidavit, Note Exhibit)
2. "the motion papers showed that such claim [the aborted underwriting assertion] has substance" (Brief in Opp., p. 19)	misleading and incorrect	22. Actually, the record shows that Bogue rejected the underwriter and not vice versa. (Guttenberg Affidavit, para. 21). The motion papers reveal anything but "substance" for this assertion of a lost underwriting in connection with the loans. The motion papers are based on the hearsay of one not a party to the underwriting negotiations nor an expert in underwriting. (See Zeller Affidavit, paras. 21-23; compare with Reiffin Affidavit, paras. 23-25)